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Directors' Duties to Creditors - Mapping the Twilight Zone

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DIRECTORS' DUTIES TO CREDITORS – MAPPING THE TWILIGHT ZONE

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ABSTRACT & KEYWORDS

This thesis examines Canadian corporate law to analyze whether its legal mechanisms (e.g., duty of loyalty, duty of care, derivative action, oppression etc.) are sufficient to protect creditor interests, their shortcomings and possible solutions. It argues that the risks to which creditors are exposed in Canada at the hands of directors when a company is financially distressed or insolvent demand more clear protection. It reviews available legal mechanisms under the English and Delaware corporate law to see if Canada could import anything to improve its lax creditor protection. The thesis suggests adopting wrongful trading provisions modeled on English legislation. The study examines and compares relevant legislation, leading case law, theoretical foundations and doctrinal legal scholarship and provides policy perspective.

INDEX TERMS: fiduciary duties, directors duties, fiduciary duties to creditors, fiduciary duties to creditors in insolvency, fiduciary duties of directors of corporations/company, duties of directors under corporate law, solvency, insolvency, insolvent corporation, zone of insolvency, vicinity of insolvency, near insolvency, verge of insolvency, financial distress, oppression, duty of care, derivative action, wrongful trading, insolvent trading, fraudulent trading, directors disqualification, shareholders, creditors, directors, corporations, best interests of the corporation, limited liability of company.

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INTRODUCTION

In an insolvent[1] or financially distressed[2] company,[3] there is sufficient incentive on the part of directors to encourage the company to continue to trade. This incentive may arise from directors' ownership of substantial equity in the company or from directors not wanting to lose their jobs or from a fear of reputational loss if the business liquidates. It is a truism that, in insolvent corporations, shareholders cease to have any material interest[4] in the assets of the company.[5] Also, given that directors or shareholders are not necessarily required to bring a company's business to an end when it is financially

[1] A company is insolvent when it is unable to pay its debts. It is a deceptively simple concept as there is more than one test of inability to pay debts. The meaning of the word "debt" depends on the particular test of insolvency applied and in marginal cases it may be not clear whether a test is satisfied. Insolvency is therefore not a term of art and certainly not a condition to which legal consequences attach. The only consequences occur after some formal proceeding such as winding up or appointment of an administrator or administrative receiver has taken place. Insolvency legislation confines the terms "insolvency" and "insolvent" to a formal insolvency proceeding. Thus, it is neither a criminal offence nor a civil wrong for a company to become insolvent. However, if the company is in formal insolvency proceedings and improper trading is established, then civil or criminal liability could arise under English law. (Roy Goode, *Principles of Corporate Insolvency Law*, 4th ed. (Sweet & Maxwell, 2011) at 83 [Goode])

[2] In the literature and case law, different expressions are used to express this period, common among those are: zone of insolvency, doubtful insolvency, near insolvency, verge of insolvency, amptly insolvent and vicinity of insolvency.

[3] The words company/firm/corporation are used interchangeably through out this thesis.

[4] Most corporations have limited liability for shareholders which means shareholders are not liable for any loss beyond the value of their shares e.g., if the firm goes bankrupt shareholders personal assets (e.g. their homes) can not be used to pay off creditors. The Economic rationale for limited liability is that it reduces transaction costs, as otherwise creditors would be constantly monitoring who owned the stock in order to determine how much risk they were facing. (cited from Donald A Wittman, ed. *Economic Analysis of the Law* (Blackwell Publishing, 2003) at 153 [Donald]). The most widely recognized feature of separate personality of a corporation is this principle of limited liability. It is expressly conferred on shareholders by s.45 of *CBCA*, which provides that shareholders would not be liable for any act or default of the corporation beyond the value of the shares that they hold except under certain circumstances. Provincial statutes contain similar provision see s.92(1) of *OBCA*. Thus, because of the limited liability creditors could petition for bankruptcy or apply to have the corporation wound up if it becomes insolvent but have no right of claim against the shareholders personally. A corollary aspect of this limited liability principle is that creditors of the shareholders could also not assert their claims against the assets of the company just as the company's creditors could not assert their claims against the assets of the shareholders. Thus, if a shareholder pledges his shares to secure a personal loan, the lender may seize those shares if the loan remains unpaid but creditor could not claim against the assets of the company that are not owned by that shareholder (from Paul Davies, ed. *Introduction to Company Law,* 2nd ed. (Oxford University Press, 2010) at 55)

[5] Ross Grantham & Charles Rickett, eds. *Corporate Personality in the 20th Century*, (Oxford, 1998) at 105 [Ross Grantham] (This fact is confirmed by the rule that in schemes of arrangement involving insolvent corporations approval of the shareholders for the scheme is not needed).

distressed, a company in financial distress will be trading at the expense of the creditors. As was stated by the Cork Committee[6]: "A company will not be under an obligation to show as a certainty that its debts will be paid . . ."[7]. Thus, directors' efforts to save the company could compromise creditor interests. This shows the delicate position of creditors in a financially distressed or insolvent company and indicates why creditors of Canadian companies need some protection. In this thesis, I examine Canadian corporate law to analyze whether its mechanisms are sufficient to protect creditor interests, to identify their shortcomings and to propose possible solutions. With this endeavor in mind, I shall review various legal mechanisms (e.g. duty of loyalty, duty of care, oppression etc.) for protecting creditor interests available currently and point out their inadequacies. I shall also review and evaluate available legal mechanisms under the English and Delaware corporate law to see if Canada could import anything specifically from those jurisdictions to improve the creditors' current position. I shall also provide some policy perspectives.

I may state at the outset that, in recent years, the courts in some common law jurisdictions have adopted the approach that directors owe a fiduciary duty[8] to creditors when a corporation becomes insolvent or is in the vicinity of insolvency.[9] In Canada, the situation is not so transparent. In a recent decision, the Quebec Superior Court extended the directors' fiduciary duty and duty of care to creditors in insolvency; however this

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[6] UK, "Insolvency Law and Practice: Report of the Review Committee, Cmnd 8558, presented to the Parliament by Secretary of State for Trade on June 1982. (The Report was prepared by a Committee appointed by Mr. Edmund Dell MP, Secretary of State for Trade, UK, under the Chairmanship of K R Cork (now Sir Kenneth Cork) on Jan 27, 1977 to carry out fundamental and exhaustive reappraisal of all aspects of the existing insolvency laws of England and Wales and to make recommendations thereon)[Cork Report]

[7] Ross Grantham, *supra* note 5 at 113

[8] Equity developed the concept of fiduciary duty to deal with the risk of abuse where one party to another, places extensive reliance, which has now been given legal formulation in the corporate statutes.

[9] *Geyer v Ingersoll Publications Co*, 621 A 2d 784 (Del Ch 1992) [*Geyer*]; *Credit Lyonnais Bank v Pathe Communications Corp*, 1991 WL 277613 (Del Ch), 17 Del J Corp L 1099 [*Credit Lyonnais*]; *Production Resources Group, LLC v NCT Group Inc.* 863 A 2d 772 (Del Ch 2004) (direct fiduciary duty); *North American Catholic Educational Programming Foundation Inc., v Rob Gheewalla*, WL 2588971 (Del Ch 2006) at 10 (Note: the matter proceeded to Delaware Supreme Court 930 A. 2d 92 (Del Sup Ct 2007). I have referred to both as [*Gheewalla*] though mentioned the level of court when making a point or discussing their opinion/views) (indirect); *Winkworth v Edward Baron Development Co Ltd and Others* [1987] 1 All ER 114 (direct but dicta) [*Winkworth*]; *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd,* [2003] 2 BCLC 153 (indirect) [*Gwyer*]

approach was rejected by the Court of Appeal and by the Supreme Court of Canada (SCC).[10] The SCC, however, recognized that directors under certain circumstances might be found liable for breach of the duty of care to creditors. In a later decision in a separate matter, the Court explained that directors' duty of care to creditors does not give rise to an independent cause of action.[11] In a more recent decision of the Ontario Superior Court on a motion for dismissal of action, the court suggested that a duty of care could still be extended to creditors under common law if not by statute.[12] These judgments have created an ambience of uncertainty surrounding directors' duties to creditors in Canada. Hence, there is a need to review and evaluate existing legal mechanisms for creditors in other major jurisdictions such as England and Delaware in order to find some other solutions to make the protection of creditors more clear in Canada.

I have suggested adopting a wrongful trading[13] sort of provision in Canadian corporate statutes and have offered several policy reasons in favour of it in chapter 5. I have also discussed the arguments against extending any such protection to creditors in chapter 5. However, at the start of my analysis I would like to briefly discuss a few policy aspects/reasons for making this suggestion in order to give a general overview of the context of my arguments and research. Wrongful trading is a legal mechanism that fulfills competing public policy concerns. Wrongful trading provisions are efficiency enhancing. There is no empirical evidence suggesting that these provisions are in any way value destroying or cause over capitalization by increased risk aversion. On the contrary, they are aimed at achieving responsible risk-taking and competence in directors. The mechanism could in fact lead to improved company procedures and financial practices. Value is a subjective term. In my view, condoning irresponsibility and wrongfulness has costs and systemic implications that are more value destructive than other values. In company law, efficiency is important. Company law must operate smoothly and unnecessary costs minimized for the prosperity of businesses and society at large. But

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[10] *Peoples Department Stores Inc. (Trustee of) v Wise,* 1998 CarswellQue 3442 (WL Can) [*Peoples Superior Court*]; *Peoples Department Stores Inc. (Trustee of) v. Wise,* [2003] J.Q no 505 [*Peoples QCA*]; *Peoples Department Stores Inc. (Trustee of) v Wise*, 2004 SCC 68 (CanLII) [*Peoples SCC*]
[11] *BCE Inc v 1976 Debentureholders,* 2008 CanLII 69 (SCC) [*BCE*]
[12] *Festival Hall Developments Ltd v Wilkings,* 2009 CarswellOnt 3312 (Ont. SCJ) (WL Can) [*Festival Hall*]
[13] For a discussion on wrongful trading provisions see chapter 3 part II; also analysis in chapter 5.

company law must also achieve other goals like the promotion of high standards of behaviour by directors and their accountability. It is the function of the law to set those standards below which directors should not be allowed to fall. Setting those standards is not a function of efficiency alone.[14] Thus, supplementing self-help (in the form of contracts) with legal protection directors' decision-making process could be restructured when the company nears insolvency.[15]

It may be argued that, as creditors have the advantage of negotiated contracts there is no need to give legal protection to them when the same is not offered to shareholders who may also lose money in case of liquidation of the company. However, creditors bargain for something different as compared to shareholders and are particularly vulnerable in the context of a financially distressed corporation. Shareholders have substantive legal rights and remedies that protect their investment. As insolvency looms, the shareholders' equity interest in the company is essentially disappeared and the only meaningful interest remaining is that of creditors. Contracts do not provide complete protection. Directors have to exercise discretion that becomes all the more important in or near insolvency and that is why wrongful trading provisions are important in order to give legal protection to creditors when their interests are vulnerable. When a corporation borrows money, it is under a legal obligation to repay it. Also, the argument that creditors enjoy high interest rates and that they voluntarily enter into negotiated arrangements does not justify allowing the directors to impair the left over assets of the company with impunity when it is financially distressed. Directors are required to manage the company in accordance with their legal obligations including to act honestly and in good faith in the best interests of the corporation and to exercise the diligence expected of a reasonably prudent person. Agency law along with the separate legal personality of the company protects directors from personal liability on corporate contracts. In insolvency, the trustee or liquidator has

[14] UK, LC261/SLC173, Report, "Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties (22 September 1999) at para 3.10 [LC261] online at Law Commission UK web-site <http://lawcommission.justice.gov.uk/docs/lc261_Company_Directors.pdf> (this report preceded a consultation paper that usefully sets out the Commission's understanding of current law. The second Report UK, LC246, Report, "Shareholder Remedies" (24 Oct 1997) is also available online at <http://lawcommission.justice.gov.uk/docs/lc246_Shareholder_Remedies.pdf> it also preceded a consultation paper.

[15] Davies, *supra* note 4 at 89

no claim at all against them for a contribution to the assets of the insolvent company.[16] In a profitable and well-capitalized corporation, the economic interests of shareholders are paramount but, when the corporation starts to struggle financially, the residual rights of shareholders generally become worthless. It is the creditors' interests that are directly at stake. Any unsafe course by directors could potentially minimize the value of their claims against the assets of the corporation. Creditors have very limited legal means at their disposal in this context.

Some might argue that a wrongful trading sort of provision privileges creditors unduly. However, such a view fails to consider adequately the creditors' position in the corporation as compared to shareholders. Creditors only receive an interest payment. Importantly, shareholders are the only privileged constituents who elect and remove directors under most corporate law statutes.[17] It is rare for creditors (secured or unsecured) to carry rights to elect the corporation's directors. It is also debatable if directors would be willing to enter into contracts that contain terms for their replacement. Thus, it is highly unlikely that creditors may be able to invoke contractually specified events of default to replace the existing board of directors if found to be acting against their interests in a financially distressed company. Also, creditors have limited resources generally to assess the credit worthiness of a corporation except for large public corporations that constitute only a small fraction of Canadian business corporations.[18] There is no requirement for private companies to publish accounts. It follows that there are policy reasons supporting the need for enhancing the legal protection of creditors in the context of a financially distressed corporation and wrongful trading provisions are one way to achieve it. No doubt, creditors could bargain for contractual protection but it is not a universal truth that all creditors are protected by some form of security and that all creditors have any meaningful bargaining power. Legal protection is not a windfall on unsecured creditors and it certainly is presumptive and naïve to say that they freely choose not to demand security. Not everyone is a sophisticated lender with the ability to

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[16] Davies, *supra* note 4 at 54

[17] For example, s.106(3) of the *CBCA* expressly states that the shareholders must vote to elect directors by ordinary resolution at the annual meeting of the company

[18] See FN 690

understand the intricacies of lending to a company or the importance of obtaining security. The extension of legal protection to these unsecured creditors reflects on how we as a society address the inequities created by financial distress of active businesses. Contracts do not provide complete protection. Also, there is often pressure to lend for business reasons without security.[19] There is case law that suggests some debtors were able to obtain loans voluntarily and without any security by simply exploiting the good nature and trust of lenders.[20] There is, thus, a need to be sensitive to the position of unsecured creditors especially. I argue that a default or mandatory rule in the form of a wrongful trading sort of provision addresses these concerns.

This thesis is divided into 5 chapters.[21] Chapter 1 is the introduction.

Chapter 2 reviews the Canadian law on directors' duties to creditors in insolvency and reviews the existing legal mechanisms to protect creditors along with important jurisprudence developed thereon. In this chapter, my examination is restricted only to Federal and Ontario legislation.

Chapter 3 discusses directors' duties to creditors in England[22] including the various specific legal mechanisms adopted therein for creditor protection and important case law. Chapter 3 is divided into three Parts. Part I of chapter 3 discusses the English *Companies Act 2006,* c.46 (*CA 2006*)[23]. Part II of chapter 3 considers the wrongful trading provisions under the English *Insolvency Act 1986,* c.45 (*IA 1986*)[24] and disqualification of directors

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[19] Jacob S Ziegel, "Creditors as corporate stakeholders: The quiet revolution – An Anglo Canadian perspective" (1993) 43 U Toronto L J 511 at 530 [Ziegel, "Creditors Stakeholders"]

[20] *Perez v Galambos*, 2006 Carswell BC 1523 (BC SC) at para 62 [*Perez*]

[21] I have tried to be accurate and up to date in the statement of law. However any errors or omissions are totally mine and regretted.

[22] England is part of the United Kingdom (UK). The UK consists of four separate countries that have three separate legal jurisdictions (England and Wales, Scotland and Northern Ireland). Each jurisdiction has its own court system. This thesis covers the legal forms of corporations for England and Wales, which is basically encompassed in the *CA 2006*. The U.K. government maintains an extensive collection of laws in force on its Web site at www.gov.uk. The Companies House, which handles registration issues for companies, is at www.companies-house.gov.uk

[23] http://www.bailii.org/uk/legis/num_act/2006/ukpga_20060046_en_1.html

[24] http://www.legislation.gov.uk/ukpga/1986/45/contents

under the *Company Directors Disqualification Act 1986* c.46[25] (*CDDA 1986*). Part III of Chapter 3 examines the fraudulent trading provisions under the *IA 1986*.

Chapter 4 evaluates the law on directors' duties to creditors and legal mechanisms for protection in light of important jurisprudence developed in the USA. In studying United States corporate law, it was not practical to examine all 50 states together with the complexity of the federal/state dichotomy. Most influential cases on fiduciary duties of corporate directors in the United States have been decided by the Delaware courts and, in transactions involving the law of states other than Delaware, practitioners and courts frequently look to Delaware for guidance. This study, therefore, focuses on the Delaware[26] cases and statutory law.

Chapter 5 contains my final thoughts and conclusions.

[25] http://www.bailii.org/uk/legis/num_act/1986/ukpga_19860046_en.pdf
[26] http://corp.delaware.gov/

2

CANADA

2.1 General Overview

The current *Canada Business Corporations Act* (*CBCA*)[27] closely follows a draft proposed by the three-man Dickerson Committee in 1974.[28] The Dickerson Committee in its proposed amendments followed the enabling philosophy of the US Model Business Corporations Act while incorporating some distinctively British provisions, in particular for minority protection (including a broad oppression remedy). Key developments included: abolition of the distinction between public and private companies; abolition of share par values and authorized share capital limits; simplification, but not complete removal, of the capital maintenance regime; enabling of single shareholder corporations; abolition of the ultra vires doctrine (companies to have all the powers of a natural person); codification of directors' duties and liabilities and of the law on dividends; and creation of a statutory derivative action on US lines. Accounting rules were removed from the legislation and subjected to professional regulation. The *CBCA* has been followed by the provincial corporate statutes[29] of most Canadian provinces particularly Ontario.[30]

The corporate law consequences of the corporation's winding up[31] are dealt with under the incorporating legislation,[32] such as the *CBCA* or the Ontario *Business Corporations*

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[27] *Canada Business Corporations Act,* RSC 1985*,* c C-44 (*CBCA*)
[28] Robert W. Dickerson, John L Howard & Leon Getz, *Proposals for a new Business Corporations Law for Canada*, vol 1 (Ottawa: Information Canada, 1971) [Dickerson Report]
[29] *CBCA* is not followed in Nova Scotia or British Columbia, which are still significantly similar to old versions of British company law
[30] Consultation Document Ref: URN 99/654, "Modern Company Law for a competitive economy: the strategic framework" (Feb 1999) available online at Department for Business Innovation & Skills, UK at para 4.4 - 4.5 <http://www.bis.gov.uk/files/file23279.pdf>
[31] In Canada and the US, jurisdiction over bankruptcy is at the federal level and companies are incorporated at the state or provincial level whereas in England both these jurisdictions are at the national level of government, which makes a full integration of corporate and insolvency law.
[32] Halsbury's Laws of Canada, 1st edition, *Business Corporations* (LexisNexis, 2008) at HBC-348 [Halsbury's Canada]

Act (*OBCA*[33]). The winding up of an insolvent corporation is carried out under the *Bankruptcy and Insolvency Act* (*BIA*)[34] or the *Companies' Creditors Arrangement Act*.[35] The winding up of a corporation is the process by which the ongoing operations of a corporation are brought to an end, its assets are realized, its liabilities discharged, the persons liable to contribute to any shortfall are identified and collected from and in connection therewith all necessary accountings are made and disputes concerning it are settled or otherwise resolved. The winding up process is sometimes called liquidation[36] as the process normally results in conversion of all assets of the corporation into money. A corporate operative known as the liquidator conducts every winding up. The liquidator's job is to realize the property of the corporation, pay its debts and distribute any remaining amount to the shareholders.[37]

2.2 Nature of the duty owed to the corporation

In the corporate law context, fiduciary duties are legal norms imposed on the directors of a corporation that regulate their conduct in that capacity.[38] In Canada, directors owe their fiduciary duties to the corporation itself and as a general rule neither the shareholders nor the creditors of a corporation are beneficiaries of the fiduciary relationship nor could they enforce those duties other than by way of the derivative action.[39] Section 122(1)[40] of the

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[33] Ontario *Business Corporations Act,* RSO 1990, c B.16
[34] (CAN) RSC 1985, c B-3
[35] (CAN) RSC 1985, c C-36
[36] There are several different procedures that may be followed in the liquidation of a corporation. There are three methods of liquidation under the incorporating statutes (1) A court liquidation instituted by the corporation itself (voluntary liquidation) (2) liquidation by the court on the application of a shareholder, creditor or other person authorized under the legislation (involuntary or compulsory liquidation) (3) liquidation which begins as voluntary, shareholder driven but then continues under court supervision. However liquidation may also take place outside of incorporating statutes. Where corporation is insolvent, its business may be liquidated under the provisions of the *BIA*, either by way of assignment into bankruptcy (voluntary) or on petition by a creditor (involuntary). A corporation may also be liquidated informally under contractual arrangement usually by way of the private appointment of a receiver and manager.
[37] Halsbury's Canada, *supra* note 32 at HBC-348
[38] Mark Vincent Ellis, *Fiduciary Duties in Canada*, loose-leaf (Ontario, Carswell) vol 2, at IF-17 [Ellis]
[39] Halsbury's Canada, *supra* note 32 at HBC-254
[40] **Section 122 of *CBCA*: Duty of care of directors and officers** (excluding irrelevant portion)
"(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."

CBCA establishes two distinct duties of directors. The first is the fiduciary duty, which requires directors to act honestly and in good faith with a view to the best interests of the corporation. This provision is replicated in s.134(1)(a)[41] of the *OBCA*. The second is commonly referred to as the duty of care. It imposes a legal obligation upon directors to be diligent in supervising and managing the corporation's affairs. The statutory duty of care in s.122(1)(b) of the *CBCA* is owed to creditors as well[42] (enforced by derivative action other than in Quebec)[43] but s.134(1)(b) of the *OBCA* restricts the duty to the corporation.

Janis P. Sarra and Ronald B. Davis are of the view that, under the common law, a director would be found to owe a direct fiduciary duty to one or more creditors, if three conditions are met: (1) the director has scope for the exercise of some discretion or power (2) the director could unilaterally exercise that power or discretion so as to affect the creditor's legal or practical interests (3) the creditor is vulnerable to the fiduciary holding the discretion or power. They are of the view that such a relationship is rare within a commercial context. However, if found, a court would exercise its authority to grant a remedy even though no such direct fiduciary obligation has been granted to creditors by corporate statute.[44] However, in *Perez v Galambos*[45], it has been held by the SCC that "it is fundamental to *ad hoc* fiduciary duties that there be an undertaking by the fiduciary, which may be either express or implied, that the fiduciary will act in the best interests of the other party."[46] To put it simply, it is not enough that the alleged beneficiary of the duty is vulnerable in the absence of an express or implied undertaking by the fiduciary to act in the best interests of the other party. The court further held that "not all power-dependency relationships are fiduciary in nature, and identifying a power-dependency relationship does not, on its own, materially assist in deciding whether the relationship is

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[41] **Section 134 of *OBCA*: Standards of care, etc., of directors, etc.** (excluding irrelevant portion)
"(1) Every director and officer of a corporation in exercising his or her powers and discharging his or her duties to the corporation shall,
(a) act honestly and in good faith with a view to the best interests of the corporation."
[42] *Peoples SCC, supra* note 10 at paras 1, 57 & 66; also *BCE supra* note 11 at para 88
[43] See my discussion under chapter 5
[44] Janis P Sarra & Ronald B Davis, *Director & Officer Liability in Corporate Insolvency,* 2d ed. (Markham: LexisNexis, 2010) at 20 [Sarra]
[45] *Perez v Galambos,* 2009 CarswellBC 2787 (SCC) [*Perez SCC*]
[46] *Perez SCC, supra* note 45 at para 66

fiduciary or not".[47]

The legal doctrine used by courts in evaluating the potential liability of a corporate director to the corporation for damages allegedly sustained as a result of the director's lack of due care or attention is referred to in the law as the business judgment rule.[48] It is a common law standard of judicial review that originates[49] from American jurisprudence. The rule refers to the judicial policy of deferring to the business judgment of directors in the exercise of their decision-making.[50] The business judgment rule establishes a presumption[51] that in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation. It is a complex rule. It is now settled that the business judgment rule[52] forms part of Canadian corporate law.[53] Under Canadian jurisprudence the principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions.[54] The court looks to see that the directors made a reasonable decision not a perfect decision. As long as the directors select one of several alternatives deference is accorded to the board's decision.[55] It appears that this deference is accorded to duly diligent decisions rather than substantive or sound judgment.[56] The SCC invoked the business judgment rule in *Peoples Department Stores Inc. (Trustee of) v Wise* (*Peoples*)[57] in absolving directors from liability. But it did not carry out a rigorous review of directors' business judgment.[58] The rule is in its developmental phase in Canada and its application is not very clear. It is considered partly an evidentiary

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[47] *Perez SCC, supra* note 45 at para 74

[48] Klaus J Hopt et al, eds, *Comparative Corporate Governance: the state of the art and emerging research* (Oxford: Clarendon Press, 1998) at 326 [Hopt]

[49] The name originates from the U.S jurisprudence, but the principle has been part of the Canadian law for a long time, and the Canadian business judgment rule differs from the US rule.

[50] Fletcher Cyclopedia of the Law of Corporations, 3A Fletcher Cyc. Corp, chapter 11, sub-heading XXVII, Para D at § 1036 (at Westlaw US) [Fletcher Cyc]

[51] See para 4.2 below

[52] I have discussed it under para 4.2 below

[53] *Peoples SCC, supra* note 10; Kevin McGuinness, *Canadian Business Corporations Law*, 2nd ed. (LexisNexis, 2007) at 937 [McGuinness]

[54] *UPM-Kymmene Corp. v UPM-Kymmene Miramichi Inc.,* [2002] CarswellOnt 2096 at para 153 (WL Can) [*UPM*]

[55] *Maple Leaf Foods Inc. v. Schneider Corp.,* 1998 CanLII 5121 at 36 [*Maple Leaf*]

[56] Sarra, *supra* note 44 at 49

[57] *Peoples, supra* note 10

[58] See my analysis in chapter 5, also para 4.2 below

presumption based on the assumption that directors are entitled to the benefit of any doubt. It accordingly applies only in so far as there is insufficient evidence to rebut this assumption such as evidence confirming fraud, bad faith and self-dealing[59] or failure to be informed.[60] In the absence of this evidence, the board's decision is upheld unless the evidence suggests that the board's decision (at the time it was made) was so outlandish that it could not be in the interest of any rational business purpose.[61] If the risk is of greater nature the director may be liable for breach of the fiduciary duty as well as the duty of care.[62] Thus, directors are expected to exercise proper business judgment in exercising their duties under s.122(1) of the *CBCA*.[63]

2.3 Duty owed to creditors in insolvency

As a company becomes insolvent, the directors' fiduciary duties do not shift to creditors.[64] Directors continue to act in the best interests of the corporation under corporate law, although their conduct could give rise to a claim for breach of duty of care to creditors under the *CBCA*[65] but not the *OBCA*.[66]

The nature of the duties imposed on directors by s.122(1) of the *CBCA* was recently considered in *Peoples*[67] by the SCC. This case provides an illustration of the context for my research as to whether Canadian law protects creditors adequately in insolvency. The case attracted academic attention not only for issuing conflicting statements of law but also for suggesting *inter alia* the availability to creditors of the company oppression remedy. Remedies for breach of fiduciary duties and oppression are policy remedies designed for particular kinds of conduct and should be viewed in the context of their proper policy objective. The rationale for fiduciary duties comes from equity. The

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[59] Halsbury's Canada, *supra* note 32 at HBC-229
[60] *Maple Leaf, supra* note 55 at para 33
[61] Halsbury's Canada, *supra* note 32 at HBC-229
[62] Halsbury's Canada, *supra* note 32 at HBC-229
[63] See more under para 4.2 below
[64] *Peoples SCC, supra* note 10 at 43
[65] *Peoples SCC, supra* note 10 at 57
[66] Sarra, *supra* note 44 at 50; also see FN 40 & 41 above to note that s.134(1) of the *OBCA* expressly states that directors owe duties to the corporation; also see para 2.4 below
[67] *Peoples SCC, supra* note 10

corporation has a fictional existence as it must be directed by acts and decisions of corporate directors who are given significant powers to manage and supervise the business of a corporation in exercising discretion to carry out their functions. It is clear that with such unfettered discretion there is always a possibility of abuse. To deal with the risk of this abuse equity developed the concept of fiduciary duty which has been incorporated into corporate law. It is now settled that the directors of a corporation occupy a fiduciary position *vis-à-vis* the corporation which they serve.[68] Thus, fiduciary duties serve as a tool to create incentives (or threats) to improve directors' performance in order to deal with various agency problems that could arise from their role in the corporation.[69] Oppression on the other hand is considered a policy weapon to protect minority shareholders (as originally envisaged by the Dickerson Committee although the remedy is available to others as complainants as well)[70] against the abuses of management and/or majority shareholders. Other academics state that the basic intent behind s.241 and its equivalents across Canada is to provide relief formerly provided for in applications for the winding up of the corporation without the necessity of proving that the circumstances are such that it would be just and equitable to order a winding up.[71] This view is influenced by the origin of this remedy, which was first introduced in s.210 of the English *Companies Act 1948* (*CA 1948*).[72] Another academic view describes oppression as the broadest, most open-ended shareholder remedy in the common law world.[73] These views confirm that the policy objective of these remedies is shareholder specific but used by creditors. It does not substitute a specific mechanism like the wrongful trading provisions in England, which is designed to look after creditors' interests when the corporation is insolvent or near it.

Peoples involved Wise Stores Inc.'s (Wise Inc.) acquisition[74] of Peoples Department

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[68] McGuinness, *supra* note 53 at 998
[69] Len Sealy & Sarah Worthington, *Sealy's Cases and Materials in Company Law* (Oxford University Press, 2010) at 299 [Sealy]
[70] See s.238 of *CBCA;* para 2.6 below
[71] Halsbury's Canada, *supra* note 32 para HBC-297; also Robert Yalden et al, *Business Organizations: Principles, Policies and Practice* (Toronto: Emond Montgomery Publications, 2008) at 840 [Yalden]
[72] Yalden, *supra* note 71 at 840
[73] *Peoples SCC, supra* note 10 at para 48
[74] Share purchase agreement executed in June 1992 and July 16, 1992 was closing date

Stores Inc. (Peoples Inc.) from Marks and Spencer Canada Inc. (M&S) in July 1992. Lionel Wise, Ralph Wise and Harold Wise (the Wise brothers) were the majority shareholders, officers and directors of Wise Inc. The share purchase agreement prohibited merger of Peoples Inc. with Wise Inc. until the purchase price was fully paid. Wise Inc. accordingly incorporated a new company for acquiring shares of Peoples Inc. from M&S.[75] The $27 million share acquisition proceeded as a fully leveraged buy-out.[76] The amount of $5 million was borrowed from the TD Bank.[77] The rest was required to be paid over a period of eight years.[78] To protect its interests M&S took security on all the assets of Peoples Inc.[79] On January 31, 1993 the new company was amalgamated with Peoples Inc. and became Wise Inc.'s wholly owned subsidiary. The Wise brothers became Peoples Inc.'s only directors. Almost from the outset, the joint operation of Wise Inc. and Peoples Inc. did not function smoothly. Parallel bookkeeping, together with shared warehousing arrangements caused serious financial problems for both companies. Their inventory records were seriously affected. In October 1993, the Wise brothers consulted with the Vice President of Administration and Finance of both companies and, upon his recommendation agreed to implement a joint inventory procurement policy. It was agreed that the two companies would divide responsibility for purchasing inventory. Peoples Inc. was required to make all purchases from North American suppliers and Wise Inc. from overseas suppliers. Peoples Inc. was then required to charge and transfer to Wise Inc. the inventory purchased on its behalf and vice versa. The said policy was implemented on February 1, 1994, and in December 1994, upon viewing disappointing financial statements M&S filed bankruptcy proceedings against both companies. The companies were declared bankrupt on January 13, 1995 effective December 9, 1994.

Following bankruptcy, Peoples Inc.'s trustee commenced proceedings against the Wise brothers alleging that, in their capacity as directors, they favored the interests of Wise Inc. over Peoples Inc. causing harm to the latter's creditors. The trustee claimed that their conduct breached duties imposed by s.122(1) of the *CBCA*. The trial judge Greenberg J.

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[75] *Peoples SCC, supra* note 10 at para 9
[76] *Peoples SCC, supra* note 10 at para 9
[77] *Peoples SCC, supra* note 10 at para 10
[78] *Peoples SCC, supr*a note 10 at para 10
[79] *Peoples SCC, supra* note 10 at para 11 (subject to a priority in favour of TD Bank)

relying on decisions from various common law jurisdictions, held that the fiduciary duty and the duty of care under s.122(1) of the *CBCA* extend to a company's creditors when a company is insolvent or in the vicinity of insolvency.[80] The trial judge noted that there was a reckless disregard by the directors of the negative financial implications resulting from that new policy which protected Wise Inc.'s interests rather than those of Peoples Inc.[81] The judge noted that the directors perpetuated their negligence to the very end by never monitoring the amount of debt resulting from Peoples Inc.'s assumption of most of the cost of Wise Inc.'s purchases.[82] In the opinion of the trial judge, the creditors were the "stakeholders" or the persons affected by the decisions of the directors. The directors in his view should be held personally liable for breach of their duty to creditors under these circumstances.[83] The trial judge cited a number of judgments from the UK, Australia and New Zealand. He concluded that Canada's business corporations law should evolve in the direction that those authorities advocate.[84] Keay criticizes the judgment of Greenberg J. by saying that it goes further than the foreign decisions cited by him. He comments[85] that it should not be surprising that Greenberg J. accepted the notion of directors' direct duty to creditors considering he relied on a controversial dicta of Lord Templeman in *Winkworth v Edward Baron Development Co Ltd and Others.*[86] Keay's criticism, in my view, is limited to Greenberg J.'s judgment and not to the soundness of the underlying premise that creditors require more protection in Canada.

The Quebec Court of Appeal overturned the lower court's decision and rejected the concept that the duties of the directors shift in favour of the creditors of the corporation when insolvent or in the vicinity of insolvency. The Quebec Court of Appeal considered it as an innovation to law, which only Parliament is allowed to do and not the courts. In the court's analysis, the trial judge also confused the two distinct duties laid down under s.122(1) of the *CBCA*. Pelletier J.A. of the Court of Appeal, in his reasons specifically

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[80] *Peoples SCC, supra* note 10 at para 27
[81] *Peoples QCA, supra* note 10 at para 42
[82] *Peoples QCA, supra* note 10 at para 41
[83] *Peoples QCA, supra* note 10 at para 45
[84] *Peoples QCA, supra* note 10 at para 46
[85] Andrew Keay, *Company Directors' Responsibilities to Creditors* (London; NewYork: Routledge-Cavendish, 2007) at 167-168 [Keay, *Responsibilities to Creditors*]
[86] *Winkworth, supra* note 9 at 118

stated: "In 1978 the Canadian law was completely revised without the legislators' explicit acceptance of the principle of the general liability of directors to third parties . . . In the case at bar, I therefore believe that it is not within the purview of the courts to decide that corporate law should evolve in a manner that the legislator did not provide for in his reform."[87] He thus was not in favour of the court doing the legislator's job. But the SCC did not state that it was limited in any way in its interpretation of s.122. The SCC instead extended directors' duty of care to creditors when, historically, it has always been owed to the corporation alone. Thus, the SCC effectively indicated that the Court of Appeal was wrong to conclude that it was not within the purview of the courts to reform the law in this way. That said I am not arguing that fiduciary duties be extended to creditors by courts but the point is creditors need more in terms of legal mechanisms that require directors to consider their interests like the wrongful trading provisions in England in the circumstances when the corporation is insolvent or approaching it.

Pelletier J.A. made an interesting comment: "I am very reluctant to link the rights of creditors with those of shareholders, even when bankruptcy is imminent. I note in passing that the property of the corporation is not that of the shareholders, even from a practical standpoint and I have difficulty seeing why it would be more likely to become the property of the creditors solely because bankruptcy is imminent."[88] If Pelletier J.A.'s comment has any force then I am tempted to ask why are shareholders given legal protection? The same logic that works to protect shareholders' interests should apply to creditors when the corporation is not financially sound. It may be true that shareholders do not own the company legally but they are its owners in the economic sense of the word. However, when a company is near insolvency their residual economic interest is exhausted; a fact which SCC has itself accepted.[89] If this logic is true, then absent shareholders' interest, the only valid stake remaining in the corporation is that of its creditors. It is in this sense that the word "shift" arguably may be used. There are laws to protect the economic interests of shareholders but not many legal mechanisms to protect creditors against directors' wrongdoing. At the very least, that raises the question as to

[87] *Peoples QCA, supra* note 10 at paras 93 & 95
[88] *Peoples QCA, supra* note 10 at para 97
[89] *Peoples SCC, supra* note 10 at para 45

whether creditors are adequately protected in Canada or need more protection. Pelletier J.A. further stated that: "the actions allegedly taken to the detriment of the creditors consisted in the adoption and implementation of the joint inventory procurement policy. But the adoption dates back to November 1993 and the implementation to February 1994, two periods when no one foresaw the possibility of bankruptcy. In short, the theory of the shifting of the shareholders' interests to the creditors because of the imminent bankruptcy finds no real echo in the facts giving rise to the dispute that must be decided."[90] This in my view is a very sweeping remark. The facts are clear that the two companies were financially struggling. In fact, the financial statements prepared to reflect the financial position of Peoples Inc. as of April 30, 1994 confirmed that Wise Inc. owed more than $18 million to Peoples Inc. It is also mentioned that around the end of January 1994, Peoples Inc.'s sales volume fell some $32 million below forecast.[91] This is a huge sum. The directors did nothing to repudiate the adoption of the procurement policy knowing the fragile state of the company. In my view, if Canadian law had obligated directors to take account of creditors' interests against wrongful trading as required in other common law countries, then the facts would have favored creditors to make a claim on that ground.[92] Creditors in Canada need more protective measures.

The matter finally came before the SCC in 2004.[93] The principal issue of the appeal was whether the directors of a company owed a duty to creditors. The SCC concluded that at all times the directors owe their fiduciary duties to the corporation and the corporation's interests are not the interests of the creditors. It clearly stated that the directors of a company, even when the company is facing insolvency, do not owe a fiduciary duty to the creditors of the company. The SCC confirmed that, "the fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency"." It may be noted that this phrase was not defined. The court regarded it as a concept having no legal meaning. However, the court acknowledged that it conveys deterioration in the corporation's financial stability. It stated categorically that there is no need to read the

[90] *Peoples QCA, supra* note 10 at para 103
[91] *Peoples QCA, supra* note 10 at para 31
[92] See my comments in chapter 5 where I have discussed the facts of this case at length.
[93] *Peoples SCC, supra* note 10

interests of creditors into s.122(1)(a) as creditors have recourse to the oppression remedy and an action for breach of the duty of care. The SCC did not find the directors liable for breach of the fiduciary duty as there was no fraud or dishonest action on their part nor were they found guilty of a breach of the duty of care as the implementation of the new policy was considered a reasonable business decision.[94] This conclusion is a clear-cut recognition that directors who act honestly and in good faith in the best interests of the corporation are unlikely to be accountable personally. This rationale lacks policy merit if directors with knowledge of their company's inability to pay back accept credit from creditors who have no such knowledge or with knowledge of the financial distress of the company indulge in irresponsible behaviour that renders the company's position worse such that it has less money available to pay creditors or who act incompetently, ignorantly or indifferently when the company is in financial distress. It may be asked that, if the directors are doing their best and the company fails, how is this different from the situation faced by every prospective lender; i.e. if the company fails, the creditors will not be repaid. So as long as the directors have not acted out of self-interest or negligently, why should there be a remedy against them? The case law suggests that insolvent liquidation at least sometimes results from one or more mistakes.[95] It is but for the trier of the fact to determine the reasons, nature and extent of the harm caused to the creditors interests due to the continued trading of an insolvent corporation after the director concerned acquires actual or deemed knowledge that the company would not be able to avoid insolvent liquidation. A wrongful trading provision is thus a legal mechanism for aggrieved creditors to approach the court of law against the actions of directors through the liquidator. Thus, there is a need for a wrongful trading kind of duty on directors.

The SCC acknowledged that, when the corporation is in the vicinity of insolvency, the residual claims of shareholders are nearly exhausted.[96] In this situation, while shareholders prefer that the directors pursue high risk alternatives with a high potential payoff to maximize the shareholders' expected residual claim, creditors in the same circumstances prefer that the directors steer a safer course so as to maximize the value of

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[94] Canadian business judgment rule is not same as Delaware – see my analysis under chapter 4 & 5 on this
[95] *Re Hawkes Hill Publishing Co Ltd* (in Liq.), [2007] BCC 937 at 952 (*Re Hawkes*)
[96] *Peoples SCC, supra* note 10 at para 45

their claims against the assets of the corporation.[97] The SCC advised that, in using their skills for the benefit of the corporation when the company is financially troubled, the directors must be careful to act in its best interests by creating a "better" corporation and not to favour the interests of any one group of stakeholders.[98] To me, it is inconceivable to think of creating a so-called "better" corporation without compromising creditors interests when it is understood that directors would resort to risky actions to avoid liquidation. The directors need to be mindful that risk taking should not be hazardous to corporate creditors and they have to act responsibly if they know there is no reasonable prospect that the company would avoid going into insolvent liquidation. This is a more realistic and fair approach to make a "better" corporation.

The SCC on several occasions in *Peoples* made sweeping remarks such as "there was no fraud or dishonesty in the Wise brothers' attempts to solve the mounting inventory problems"[99] and "the brothers were driven solely by the wish to resolve the problem of inventory procurement affecting both the operations of Peoples Inc. and those of Wise Inc. [This is a] motivation that is in line with the pursuit of the interests of the corporation within the meaning of paragraph 122(1)(a) *CBCA* and that does not expose them to any justified criticism."[100] These statements blatantly disregard creditor interests since the SCC itself recognized that, in insolvency, creditor interests increase in relevancy.[101] If it is the creditor interests that are more relevant in insolvency, then how can we detach the interests of the corporation from the interests of creditors and let directors manage the insolvent corporation without extending more protection to creditors as in the wrongful trading provisions in England.

The SCC subsequently got an opportunity to discuss directors' fiduciary duties to creditors in *BCE Inc. v 1976 Debentureholders* (*BCE),*[102] which incidentally was not a case arising out of insolvency. However, the court made specific references to its

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[97] *Peoples SCC, supra* note 10 at para 45
[98] *Peoples SCC, supra* note 10 at para 47
[99] *Peoples SCC, supra* note 10 at para 40
[100] *Peoples SCC, supra* note 10 at para 40
[101] *Peoples SCC, supra* note 10 at para 49
[102] *BCE, supra* note 11

judgment in *Peoples* while analyzing the facts in *BCE*. The *BCE* case adds nothing new to the law on this issue. However, the court expressed its views in a manner that made some academics wonder if the SCC was shifting with respect to its *Peoples* position on directors' fiduciary duties to creditors. The court states that: "In *Peoples Department Stores,* this court found that although directors **must** consider the best interests of the corporation, it **may also be appropriate**, although **not mandatory**, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders".[103] The court's use of words "**must**", "**may also be appropriate**", and "**not mandatory**" are highly puzzling. In my view, they do not put any obligation on directors to consider creditors interests. Such words add little value to the law and instead provide cover for directorial discretion.[104] The court's holy deference to the board makes it almost impossible for company creditors to sue for wrongful conduct without specific wrongful trading sort of duty on directors.[105]

In *Peoples,* the proceedings related solely to the statutory duty of directors owed under the *CBCA*.[106] In Ontario, the common law principles are still evolving with regard to the directors' fiduciary duties to creditors. Prior to the SCC's judgment in *Peoples,* the courts in Ontario seemed confused about the scope of fiduciary duty under s.134(1)(a). In *Canbook Distribution Corp v Borins* (*Canbook*)[107], the court noted that Canadian law appears to be moving in the direction of recognizing that directors of a company owe a fiduciary duty to creditors of the company, particularly in situations where the corporation is insolvent when it enters into the challenged transaction or the challenged transaction renders the corporation insolvent.[108] In *Canbook,* the court relied on the trial judge's decision in *Peoples.*[109]

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[103] *BCE*, *supra* note 11 at para 39
[104] Ed Waitzer and Johnny Jaswal, "Peoples, BCE and the Good Corporate "Citizen"" (2009) 47 Osgoode Hall LJ 439 at 464
[105] See my analysis under chapter 5
[106] *Peoples SCC, supra* note 10 at para 42
[107] *Canbook Distribution Corp v Borins,* 1999 CarswellOnt 2016 (WL Can), [1999] 45 OR (3d) 565 (Ont. Commercial List) [*Canbook*]
[108] *Canbook, supra* note 107 at para 16
[109] That decision was reversed by SCC later (discussed above)

Although creditors are not the direct beneficiaries of this statutory duty, they may appoint a receiver over the company who could enforce the duty on their behalf. This happened in *HSBC Bank of Canada v Dillon Holdings Ltd*[110] wherein the directors were found liable for breach of fiduciary duty under s.134(1)(a) of the *OBCA* for misconduct, which rendered the company less capable of paying its liabilities.[111] However, it does not undermine the need to have more protective measures in place for creditors so that directors are aware of their responsibility towards them.

2.4 Duty of care

The duty of care requires the exercise of care which ordinary, careful and prudent persons would use in similar circumstances. This standard of care in Canada is the same as under English and Delaware law. It derives from the tort law concept of reasonable care and so the duty of care is breached when directors act in a grossly negligent manner.

In *Peoples*, the SCC expanded the scope of the statutory duty of care by applying it to the facts of that case. The duty of care is expressed in s.122(1)(b) of the *CBCA* which requires directors of a corporation "to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." This provision together with the statutory fiduciary duty generally provides a benchmark for courts to assess the conduct of corporate directors that violate remedial statutes i.e., laws that pertain to a means or method of addressing wrongs or obtaining relief.[112] A "remedial statute" provides a means for the enforcement of a right or the redress of a wrong.[113] The duty of care provision is often referred to in the remedial provisions such as pensions and environmental[114] legislation.[115] These provisions impose personal liability on directors if

[110] *HSBC Bank of Canada v Dillon Holdings Ltd*, 2005 CarswellOnt 2322 (WL Can) (Ont SCJ)
[111] Ellis, *supra* note 38, chapter 15, Directors at 15-36.2
[112] Sarra, *supra* note 44 at 44
[113] Custom Digest, Statutes 361K236, Remedial statutes, 976 Headnotes (WL US) (citation omitted), remedial statutes are construed liberally in favour of those whom the law intends to protect
[114] Section 194 of the Ontario *Environmental Protection Act* RSO 1990 c E.19 (places a duty on every director of a corporation that engages in an activity that may result in the discharge of a contaminant into the natural environment contrary to take all reasonable care to prevent the corporation from causing or permitting the unlawful discharge)
[115] Sarra, *supra* note 44 at 44 (citation omitted)

the corporation breaches those provisions. For example Ontario's pension legislation imposes personal liability on directors for the corporation's breaches of the pension legislation.[116] The court uses standards of reasonable care and diligence in determining directors' liability for conduct that violates such remedial statutes.[117] It is unclear how the duty is to be applied to creditors without a specific remedial provision to protect their interests in the statute. However, if Canada adopts wrongful trading sort of provisions under its corporate law to protect creditor interests, then the standard of the duty of care may be applied thereon similar to the way it is applied under English company law. Section 122(1)(b) provides the contextual[118] and objective standard to the duty raising the traditionally subjective common law standard of the duty of care. The SCC made clear in *Peoples* that the objective standard in s.122(1)(b) with regard to the duty of care refers to the factual aspects of the circumstances surrounding the actions of the director as opposed to the subjective motivation of the director which is the central focus of the statutory fiduciary duty under s.122(1)(a) of the *CBCA*.[119]

The duty of care, unlike the fiduciary duty, is not owed solely to the corporation and directors may be liable to creditors. This was stated in *Peoples*[120] but the general assumption is that the duty of care is owed only to the corporation itself as an incident arising out of the relationship between the directors and the corporation whose business they manage. Academics criticized the court's ruling as making no sense because any successful claim by the corporation for breach of the duty could have meant exactly the same: that the corporation will have more funds ensuring payment to creditors.[121] Academics are of the view that, in *Peoples,* the SCC extended the scope of the statutory duty of care by taking an expansive interpretation of s.122 of the *CBCA*. In the words of the court: "unlike the statement of the fiduciary duty in s.122(1)(a) of the *CBCA* which specifies that directors and officers must act with a view to the best interests of the corporation, the statement of the duty of care in s.122(1)(b) of the *CBCA* does not

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[116] Sections 109 and 110(1)-(5) of the Ontario *Pension Benefits Act,* R.S.O 1990, c P.8
[117] Sarra, *supra* note 44 at 44
[118] Primary facts plus prevailing socio-economic conditions
[119] *Peoples SCC, supra* note 10 at para 63
[120] *Peoples SCC, supra* note 10 at para 57
[121] Bruce Welling, *Canadian Corporate Law: Cases, Notes & Materials*, 4th ed. (Toronto: LexisNexis Butterworths, 2010) at 330

specifically refer to an identifiable party as the beneficiary of the duty . . . thus, the identity of the beneficiary of the duty of care is much more open ended and it appears obvious that it must include creditors."[122] The court made no accompanying common law analysis.[123] This appears to be a very generous interpretation of s.122 of the *CBCA*. Prof. Christopher Nicholls posits that the court may have mixed up the two different concepts i.e., the "tort of duty of care" which anticipates many potential beneficiaries and the "statutory duty of care" that is related to the duty to perform one's work duties with care, a concept that implies an obligation to the corporation itself. He is correct that it makes no sense why a corporate statue would impose additional personal duties on directors requiring them to protect parties other than the corporation itself.[124] The SCC's interpretation does not resonate with the common law which does not recognize a direct duty to corporate creditors.

The court, however, later explained that s.122(1)(b) does not provide an independent foundation for claims.[125] But it is still confusing because there is no mechanism to enforce it other than by way of a derivative action and the derivative action only provides a means for complainants to assert a claim of misuse of managerial power on behalf of the corporation. One of the conditions precedent for bringing such action is that it should appear to be in the interests of the corporation. It is unclear how creditors could pursue a derivative action if the harm suffered is personal monetary loss rather than an injury to the corporation. It may be pursued as a personal claim based upon negligence but for that it would be necessary that it be established that the creditor personally was owed a duty of care not the corporation and the foreseeable damage flowed to him personally rather than to the corporation.[126] That said, the relationship between a director of a corporation and the corporation's creditors is not one that has been recognized as giving rise to a

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[122] *Peoples SCC, supra* note 10 para 57
[123] Pamela L J Huff & Russell C Silberglied, "From Production Resources to Peoples Department Stores: A similar response by Delaware and Canadian courts on the fiduciary duties of directors to creditors of insolvent companies" (2006-2007) 1 J Bus & Tech L 455 at 480 [*Huff*]
[124] Christopher C Nicholls, *Corporate Law* (Toronto: Emond Montgomery, 2005) at 298-299 [Nicholls, *Corporate Law*]
[125] *BCE, supra* note 11 at para 44
[126] Halsbury's Canada, *supra* note 32 HBC-314

general duty of care under the common law.[127] It is, thus, confusing and instead of waiting for another court case for the needed clarification, it would be much more efficient to incorporate a provision that suits the needs of creditors just as England has done under its wrongful trading provisions. It will bring much clarity and consistency to the law rather than the current hotchpotch created by judicial pronouncements.

It may be for these reasons that Ontario amended s.134(1)(a) of the *OBCA* in 2007 to state specifically that directors' fiduciary duty and duty of care are both owed exclusively to the corporation. The insertion of the words "to the corporation" in s.134(1)(a) of *OBCA* rejects the SCC's said expansive interpretation[128] and, thus, blocks creditors in Ontario from having a direct recourse against directors for breach of the duty of care. No such amendment has been proposed to s.122(1) of the *CBCA* yet and a direct action based on the breach of duty of care by creditors is not available. In these circumstances, it could only proceed derivatively. Section 239 of the CBCA allows a complainant to apply to a court for leave to bring an action in the name of and on behalf of the corporation for the purpose of prosecuting the action on behalf of the corporation. That complainant could be a creditor if considered by the court to be a proper person to make the said application.

Despite the statutory amendment to the *OBCA,* a court in Ontario recently deliberated over particular circumstances giving rise to a duty of care to creditors. This case illustrates the menace that under capitalization causes to creditors.[129] It also shows the problems caused to the statutory duty of care by the *Peoples* decision. There is more need now for some sort of wrongful trading mechanism to resolve and permanently fix these issues that are important for the adequacy of creditor protection. In *Festival Hall Development Ltd v Wilkings*[130] (*Festival Hall*) the plaintiff had leased premises to Lucid Toronto for the operation of a nightclub. Magicorp had incorporated Lucid Toronto and had guaranteed Lucid's obligations under the lease. The defendant was a director of both

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[127] *Festival Hall, supra* note 12 at para 25
[128] Thus potential directors liability for breach of statutory duty of care in Ontario is restricted to where the corporation brings an action against them or those where a complainant is granted leave by court to bring a derivative action in the name of corporation.
[129] I have discussed it in chapter 5
[130] *Festival Hall, supra* note 12

Magicorp and Lucid. Magicorp Inc. also employed him as its Chairman and Chief Executive Officer. Lucid defaulted on the lease. The plaintiff sued Lucid and Magicorp for breach of covenant and obtained default judgment against them. As the corporations had no assets, the plaintiff was unable to recover on the judgment. The plaintiff then commenced a personal action against the defendant alleging that he, as director of the corporation owed a duty of care not only to the corporation but also to its creditors and that the defendant breached that duty of care, causing damage to the plaintiff. The plaintiff did not pursue a derivative or oppression action but elected to seek damages exclusively in tort. It is not clear why the plaintiff pursued an action in tort. But the reason for not bringing a derivative action could be because a derivative action is brought on behalf of the corporation with leave of the court to enforce directors' fiduciary duties. The plaintiff may have apprehension of not getting this leave due to the SCC's clear verdict in *Peoples* that there is no need to read the interests of creditors into the fiduciary duty as set out in s.122(1)(a) of the *CBCA*.[131] The reason for not taking an oppression action on the other hand may be influenced by the fact that the oppression remedy is based on the reasonable expectations of the parties. Creditors and the corporation do not have the relationship that shareholders typically have in the corporation.[132] Also creditors are discretionary claimants under s.238(d) of the *CBCA* and their standing to proceed with an oppression action is based on the discretion of the court. The oppression remedy does not specifically deal with negligent or wrongful trading by directors that causes loss to creditors when the company is financially struggling or insolvent such as in this case defendant improperly stripped financial resources despite dire financial situation of the companies. Thus, the plaintiff may have resorted to an action in tort out of despair to recover from directors personally considering it to be the best available remedy under the circumstances. The plaintiff argued that the defendant's self-dealing as a director gave rise to two separate heads of liability upon which a cause of action in tort could be supported. The plaintiff submitted that the defendant owed it a statutory duty of care under s.134(1)(b) of the *OBCA* pursuant to the decision of the SCC in *Peoples*.[133] The

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[131] *Peoples SCC, supra* note 10
[132] Read more on the shortcomings of Oppression remedy under para 2.6 below
[133] Section 134(1) of the *OBCA* was identical to s.122(1) of the *CBCA* at the time when material events arose in this case. s.134(1) of *OBCA* was amended in 2007

plaintiff argued that despite the fact that the companies were in a dire financial situation, the defendant improperly stripped financial resources from them and transferred them to himself. The plaintiff's position was that the defendant's improper stripping of assets from the corporations breached this duty, giving him the right to sue the defendant for the breach. Alternatively, the plaintiff submitted that the defendant owed it a common law duty of care and that the breach of that duty gave rise to an action in negligence. All of the material events in this case occurred prior to August 1, 2007. Up to that point, s.134(1) of the *OBCA* was worded identically to s.122(1) of the *CBCA*.

A motion was brought by the defendant for an order to strike down the plaintiff's action arguing that a corporate director does not owe a duty of care to the corporation's creditors.

In response to defendant's motion to strike the claim, the plaintiff heavily relied on the SCC's determination in *Peoples* that creditors are owed a duty of care under s.122(1)(b) of the *CBCA*.[134] MacDonnell J. in his reasons noted that the SCC was clear that the existence of this duty "does not entitle creditors to sue directors directly for breach of their duties".[135] The entitlement to sue, he held, had to be found within the applicable civil law, which in *Peoples* case was the QCC.[136] This was confirmed in *BCE,*[137] wherein the court had noted that in addition to the legal remedies of a derivative action or an action for oppression, stakeholders might bring a civil action for breach of the duty of care set forth in s.122(1)(b) of the *CBCA*. The court in *BCE* specifically stated:

> "As noted, s.122(1)(b) of the CBCA requires directors and officers of a corporation to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances". This duty, unlike the s.122(1)(a) fiduciary duty, is not owed solely to the corporation, and thus may be the basis for liability to other stakeholders in accordance with principles governing the law of tort and extra contractual liability: *Peoples Department Stores*. S.122(1)(b) does not provide an independent foundation for claims. However, applying the principles of *The Queen in right of Canada v.*

[134] This case was decided before *OBCA* was amended
[135] *Festival Hall, supra* note 12 at para 20 (also see *Peoples SCC, supra* note 10 para 29)
[136] *Festival Hall, supra* note 12 at para 20
[137] *BCE, supra* note 11

> *Saskatchewan Wheat Pool*, courts may take this statutory provision into account as to the standard of behaviour that should reasonably be expected."[138]

With regard to *Saskatchewan Wheat Pool*[139] it may be noted that it was held in that case that there is no nominate tort of breach of statutory duty in Canada.[140] It was established in that case that any "breach of statute, where it has an effect upon civil liability, should be considered in the context of the general law of negligence."[141] Within that context, it has been recognized that a breach of a statutory duty constitutes evidence of negligence and the statutory formulation of any such duty provides a specific and useful standard of reasonable conduct.[142] However, in Canada, there is no legal formulation for wrongful trading. Hence, there remains confusion with regard to the application of the standard of care and the breach of duty.

MacDonnell J. in *Festival Hall* noted that, as a director of a corporation with debt obligations to the plaintiff, the defendant owed the plaintiff a statutory duty of care. However, in order to determine whether conduct that fell short of the statutory standard could give rise to a cause of action in negligence, a duty of care at common law must be found. The harm caused to the plaintiff by the defendant's conduct had been pleaded in a manner that made it a foreseeable consequence of that conduct. The judge observed that the real issue was one of company law policy. The judge reasoned that the mere fact that there were policy considerations to be weighed in the assessment of whether the duty should be recognized did not preclude a negative determination of that question at the pleadings stage. The defendant's motion to strike the claim was accordingly dismissed as the court found that it was not plain and obvious that a director of a corporation could not owe a duty of care to persons such as the plaintiff in similar circumstances. This decision was not made on the merits but it is likely that the law in Ontario will evolve. Academics view the courts' recognition of common law obligations with statutory duties as a supportive sign. It is, however, vague as to how the common law would apply in

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[138] *Festival Hall, supra* note 12 at para 20 (citations omitted)
[139] *The Queen in right of Canada v Saskatchewan Wheat Pool,* [1983] 1 SCR 205 [*The Queen*]
[140] *The Queen, supra* note 139 at 225
[141] *The Queen, supra* note 139 at 225
[142] *The Queen, supra* note 139 at 227

situations where both statutory and common-law duties of directors exist.[143]

MacDonnell J. in the above case observed that company law policy is the real issue in not recognizing a duty in favour of creditors.[144] But England, Australia and New Zealand all have imposed upon directors an obligation to consider creditors' interests as part of their duties to the companies when their companies might be or are in financial distress such that creditors' money is at risk whether the company is technically insolvent or not. Liquidators and not creditors themselves challenge a breach of this obligation. Canada has from time to time followed English law and it is again time to adopt similar provisions in Canada to provide creditors adequate protection. This would accord our law with other jurisdictions and, at the same time, change company law policy and protect creditor interests adequately.

2.5 Derivative action[145]

Under the law currently, one of the remedies provided for under the *CBCA* that creditors may utilize is the derivative action under s.239.[146] A creditor may, with the leave of the

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[143] Sarra, *supra* note 44 at 23 & 24
[144] *Festival Hall, supra* note 12 at para 25 & 33
[145] Black's Law Dictionary*,* 9th ed. 2009 defines "derivative action" as "a suit by a beneficiary of a fiduciary to enforce a right belonging to the fiduciary; esp., a suit asserted by a shareholder on the corporation's behalf against a third party (usu. a corporate officer) because of the corporation's failure to take some action against the third party. A derivative claim may be distinguished from a direct claim, which is a lawsuit to enforce a shareholder's rights against a corporation.
[146] **Section 239. Commencing Derivative Action**
"(1) Subject to subsection (2), a complainant* may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.
(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that
(a) the complainant has given notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;
(b) the complainant is acting in good faith; and
(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued."
***Complainant** has been defined under s.238 of the *CBCA* as:
(a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,

court, bring (or intervene in) a derivative action in the name and on behalf of the corporation or one of its subsidiaries to enforce a right of the corporation including the rights correlative with the directors' duties to the corporation. The remedy sought must benefit the corporation. In practice, few creditors have been successful in bringing a derivative action.[147] The courts grant standing to creditors in very limited circumstances when the interest of the creditor is a direct financial interest or a particular legitimate interest in the manner in which the affairs of the corporation are managed.[148] The courts insist that a creditor seeking to bring a derivative action must be in a position somewhat analogous to that of the minority shareholder who has no right to influence what he sees as abuses of management or conduct contrary to the corporation's interests.[149] A derivative action is always brought in a representative capacity and on behalf of the corporation.[150] However, a bare creditor who is not the holder of a security may be given leave to proceed as a complainant.[151] Any recovery in such an action belongs to the corporation. However, the court has discretion to make any order any time it thinks fit including *inter alia* to direct that any amount adjudged payable by a defendant in an action be paid, in whole or in part, directly to former and present security holders of the corporation instead of to the corporation.[152] However, the said provision does not mention creditors generally and I have not found any reference in the literature to any such order made in favour of creditors by the court. The court is also vested with the discretionary power to make orders concerning the reasonable legal fees of the action concerned.[153] This power extends to complainants in connection with the action and may apply to creditors as well. The corporation typically would be ordered to fund a

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(b) a director or an officer or a former director or officer of a corporation or any of its affiliates,
(c) the Director, or (d) any other person who, in the discretion of a court, is proper person to make an application under this Part.

[147] J Anthony VanDuzer, *The Law of Partnerships and Corporations,* 3d ed. (Irwin Law, 2009) at 411 [VanDuzer]

[148] Sarra, *supra* note 44 at 82

[149] Sarra, *supra* note 44 at 83

[150] Halsbury's Canada, *supra* note 32 at HBC-314

[151] Halsbury's Canada, *supra* note 32 at HBC-315 (citing *First Edmonton Place Ltd v 315888 Alberta Ltd* [1988] A J No 511, 60 Alta L R (2d) 122 at 142-43, 156, per Macdonald J (Alta QB), 1988 CarswellAlta 103; revd on appeal [1989] AJ No 1021, 45 BLR 110 at 112, per Stevenson JA (Alta CA), 1989 CarswellAlta 181)

[152] Section 240(c) of the *CBCA*

[153] Section 240(d) of the *CBCA*

derivative action but not always.[154] Arguably, a creditor's claim may not stand a chance to succeed because allowing it to proceed at a financially distressed time may be viewed as a burden on a company's limited resources.[155] This arguably could be one of the reasons that courts are so reluctant to grant creditors leave to apply for a derivative action.

2.6 Oppression action

A second remedy under the *CBCA* is the oppression remedy provided for in s.241[156] (and corresponding provincial corporate provisions). Section 241(2) speaks of the grounds upon which a complainant may apply to the court for an order against an "act or omission" of the corporation or any of its affiliates, the conduct of "business and affairs" of the corporation and/or the "powers of the directors of the corporation or any of its affiliates". Often, the conduct complained of is the conduct of the corporation or of its directors who are responsible for the governance of the corporation.[157] A court may make a monetary order against a director to personally compensate the aggrieved parties provided (i) there are acts pleaded against specific directors which when taken in the context of the entirety of pleadings could provide the basis for finding that the corporation acted oppressively within the meaning of s.241 of the *CBCA* and (ii) a

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[154] Sarra, *supra* note 44 at 83
[155] Sarra, *supra* note 44 at 83
[156] **Section 241. Application to court re oppression** (excluding irrelevant portion)
"(1) A complainant* may apply to a court for an order under this section.
Grounds
(2) If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates
(a) any act or omission of the corporation or any of its affiliates effects a result,
(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or
(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of."
***Complainant** under s.241 means the same as under s.238 (see FN 146)
[157] Anthony J Duggan et al, eds. *Canadian Bankruptcy and Insolvency Law: Cases, Text and Materials*, 2nd ed. (Toronto, Emond Montgomery Publications, 2009) at 470 [Duggan]

reasonable basis in the pleadings upon which it could be decided that the oppression alleged would be properly rectified by a monetary order against a director personally.[158]

Most cases regarding obligations to creditors have been brought under oppression. Unlike the derivative action, which is aimed at enforcing a right of the corporation itself, the oppression remedy focuses on harm to the legal and equitable "interests" of creditors amongst others affected by oppressive acts of a corporation or its directors. The term "interests" has been given a broad interpretation[159] including *inter alia* the reasonable expectations if ignored, defeated or frustrated.[160]

To date, the courts have offered little in terms of clear guidance as to when standing as discretionary claimants under s.238(d) will be granted to a creditor to proceed with an oppression claim.[161] However, insolvency itself of a corporation may not be sufficient for a creditor to obtain relief against the directors of the corporation under the oppression provision. However, if insolvency is triggered by the misconduct of directors, a creditor may seek relief. The creditors of a corporation may reasonably expect that a corporation would fulfill its contractual commitments.[162] Thus, where a dividend or other self-serving corporate transaction renders the corporation insolvent and deprives creditors of realization of their claims, directors could be held personally liable under the oppression provisions of corporations statutes. This happened in *SCI Systems Inc. v Gornitzki Thompson & Little Co.*,[163] (GTL Co.) wherein the court found that the dividend was declared and paid to the directors themselves overriding the professional opinion of the company's auditors at a time when the directors were fully aware of the liability under the promissory note and knew that the payment would render the corporation insolvent.[164] However, the court noted that, besides the dividend payment (which is incidentally prohibited under s.38(3) of the *CBCA* if renders the corporation insolvent

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[158] Duggan, *supra* note 157 at 488
[159] Halsbury's Canada, *supra* note 32 at 298
[160] Halsbury's Canada, *supra* note 32 at 303
[161] Halsbury's Canada, *supra* note 32 at HBC-308; see also my analysis in chapter 5
[162] Halsbury's Canada, *supra* note 32 at 311
[163] *SCI Systems Inc v Gornitzki Thompson & Little Co.,* 1997 CarswellOnt 1769, 147 DLR (4th) 300 (Ont Gen Div) [*SCI*]
[164] *SCI, supra* note 163 at para 45 & 52

and recognized in the court's analysis), the shareholder loan repayments, corporate reorganizations and other transactions collectively were acts of directors that put SCI in a position where it could not recover the money owed to it.[165] As the company was unable to pay upon demand upon note the applicants obtained default judgment and as it remained unsatisfied applicants had to apply for oppression remedy. It was SCI's position that during the six-month period before the note fell due and since that time the directors caused substantial assets transferred out of GTL Co., which caused the promissory note uncollectible.[166] SCI would have resumed to deal with the remaining issues if failed to establish oppressive conduct.[167] This case is a classic example of the policy issues that arise when the company becomes insolvent due to conduct of directors and the importance to have a duty on directors towards creditors regardless of the contractual arrangement. Would it be fair to say that because the creditor did not bargain by contract for the guarantees of the personal respondents or for restrictions on the payment of dividends, it should not have benefit of mandatory legal protection in the corporate statute? Whom would we be protecting by such argument? In my view we would be protecting directors for failing to manage the company in accordance with their legal obligations namely, to act honestly and in good faith in the best interests of the corporation and to exercise the diligence expected of a reasonably prudent person. A duty to creditors would bring balance to the acts of directors in exercise of their duties to the corporation. Like in this case all of the corporate respondents were owned and operated by the personal respondents John Thompson, Jacob Gornitzki and Paul F. Little. These three individuals were the shareholders, directors and senior officers of the judgment debtor company who benefitted personally from the acts SCI complained. They received substantial dividends. They were absolved of personal liability and benefitted of the continuing business. SCI was the only one who remained disadvantaged. It was deprived of security for which it bargained and left with a worthless judgment.[168] This case raises the policy question: Could it be "equitable for the directors to recover an exposed position, to pay themselves substantial dividends, and reap the benefits of all future

[165] *SCI, supra* note 163 at para 31
[166] *SCI, supra* note 163 at para 15
[167] *SCI, supra* note 163 at para 24
[168] *SCI, supra* note 163 at para 65

business whereby in doing so they rendered valueless GTL Co.'s promise to pay SCI?” [169] In the court’s opinion it was not equitable that the directors paid themselves substantial dividends, while rendering valueless the creditor's claim. The court stated that:

> “It is a well-recognized rule that the court should not attempt to second-guess the legitimate actions of the management of corporations. This rule avoids intrusion into the day-to-day workings of the corporation and boardroom which would interfere with the conduct of business. However, equally strict is the requirement that directors must fulfill the statutory and common law fiduciary duties and duty of care that have evolved in the light of new corporate concerns and societal expectations[170] . . . They exercised their substantial powers as directors in ways that were in unfair disregard of and prejudicial to the interests of SCI. Accordingly, liability lies directly with them and the other respondents that were used as agents to effect the oppressive result.”[171]

Each case turns upon its particular facts to determine oppression and, while some degree of bad faith or lack of probity in the impugned conduct may be the norm in such cases, neither is essential to a finding of "oppression" in the sense of conduct that is unfairly prejudicial to or which unfairly disregards the interests of the complainant under the statute.[172] The onus is on the complainant to show that the corporation or those in control of it engaged in conduct that was oppressive, unfairly prejudicial or that unfairly disregarded the complainant’s interests.

The trial judge in *Sidaplex-Plastic Suppliers Inc. v Elta Group Inc.*,[173] (*Sidaplex-Plastic*) quoted the following paragraph from a case decided under the *Alberta Business Corporations Act,* envisaging the following formula for a creditor’s standing to bring an oppression action:

> “Assuming the absence of fraud, in what other circumstances would a remedy under s.234 be available? In deciding what is unfair, the history and nature of the corporation, the essential nature of the relationship between the corporation and the creditor, the type of rights affected, and general commercial practice

[169] *SCI, supra* note 163 at para 57
[170] *SCI, supra* note 163 at paras 59 & 60
[171] *SCI, supra* note 163 para 66
[172] *Sidaplex-Plastic Suppliers Inc. v Elta Group Inc.,* 1995 CanLII 7419 (Ont. Gen. Div: Commercial List) at para 13, 131 DLR (4th) 399, varied 1998 CarswellOnt 2819 (Ont. CA) (WL Can) [*Sidaplex*]
[173] *Sidaplex, supra* note 172

> should all be material. More concretely, the test of unfair prejudice or unfair disregard should encompass the following considerations: the protection of the underlying expectation of a creditor in its arrangement with the corporation, the extent to which the acts complained of were unforeseeable or the creditor could reasonably have protected itself from such acts, and the detriment to the interests of the creditor. The elements of the formula and the list of considerations as I have stated them should not be regarded as exhaustive. Other elements and considerations may be relevant, based upon the facts of a particular case."[174]

The oppression remedy does not specifically deal with wrongful trading and courts are inconsistent about oppression and creditors. A wrongful trading sort of provision would give creditors more defined and meaningful rights. Thus, even though the scope of the remedy available under the oppression provisions is allegedly broad, the courts' gate-keeping function as well as the inherent flaws of the provision makes it disadvantageous for creditors. That said, it helped creditors in *Sidaplex-Plastic*[175] and *Downtown Eatery*[176]. The oppression remedy was designed with minority shareholders in mind[177] and it therefore best serves to protect their broad interests. The oppression remedy is based on reasonable expectations. Creditors and corporations don't have the relationship that shareholders in a corporation typically have. Also, oppression is defined loosely because minority shareholders have informal arrangements as between themselves that courts uphold through an oppression action. When it comes to creditors, they don't have these informal arrangements with the corporation, typically. Directors have to exercise discretion which is important in insolvency and that is why a wrongful trading provision is important because it fills in gaps in a way that tailors to creditors specifically when their interests are vulnerable.

To summarize this chapter, *Peoples* has exposed the inadequacy of Canadian corporate law to protect creditors. As discussed, fiduciary duties do not extend to creditors when the corporation is insolvent or near it. According to the SCC, directors' duties are owed to the corporation at all times. In Canada, terms like "vicinity of insolvency" have no

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[174] *Sidaplex, supra* note 172 at para 16
[175] *Sidaplex, supra* note 172
[176] *Downtown Eatery (1993) Ltd v Ontario,* 2001 CarswellOnt 1680 (Ont. CA) (WL Can)
[177] Dickerson Report, *supra* note 28 at para 484

legal meaning. The SCC extended a duty of care to creditors. In a later court decision, it was held that such duty does not give rise to an independent cause of action.[178] The court did not provide much by way of explanation and the situation is vague with respect to its application and enforcement. But, in the absence of a direct action, the only other way to enforce a breach of the duty of care is through a derivative action. A derivative action, however, is only allowed to enforce rights of the corporation. Academics are confused and amazed at this ruling because directors have historically owed the duty of care to the corporation as per the common law. The provision has serious flaws when it comes to protecting creditors adequately as it *inter alia* does not specifically deal with wrongful trading. It is not a remedial provision and does not prevent the mischief it addresses. I have discussed the inadequacies at length in my analysis in chapter 5 also.

In Canada, the primary remedies for creditors are to bring a derivative or oppression action. Unfortunately, both these remedies suffer flaws when it comes to protecting creditor interests. The biggest hurdle is the court's gate-keeping function under which creditors' applications for leave to bring derivative actions are usually unsuccessful. No leave is required for oppression but creditors are discretionary claimants under s.238(d) of the *CBCA*.[179] A main hurdle for any potential discretionary complainant is to show that he suffered from the conduct concerned.[180] Also, a derivative action is restricted only to enforce rights of the corporation and any recovery as a result of the action belongs to the corporation. The court is vested with a discretionary power to direct that any amount adjudged payable by a defendant in an action be paid, in whole or in part, directly to former and present security holders of the corporation instead of to the corporation. However, the provision does not mention creditors generally. I have discussed the inadequacy of these provisions further in my analysis in chapter 5. These inadequacies however, point out the need for more protective mechanisms for creditors. A wrongful trading duty as it exists in England or a protection of that sort will be of value. With these thoughts, I now move on to my examination of English company law that has recently

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[178] *BCE, supra* note 11 at para 44
[179] McGuinness, *supra* note 53 at 1270
[180] McGuinness, *supra* note 53 at 1271

been adopted. My next chapter is divided into III parts. Part I evaluates the various mechanisms enforced under the *CA 2006*. I am especially interested in the wrongful trading provisions and shall discuss it at length in part II as, based on my research and analysis, I am of the view that a wrongful trading type of duty on directors to consider creditor interests is needed in Canadian corporate statutes and cases such as *Peoples* provide support for it.

3

I. ENGLAND

3.1 Introduction

This chapter is divided into three parts. Part I gives an overview of directors' duties at common law as well as under the *CA 2006* and the legal mechanisms to protect creditors. Part II traces the development of directors' duties to consider creditors' interests and discusses the wrongful trading provisions. Part III reviews another remedy for creditors - fraudulent trading. I am especially interested in the wrongful trading provisions and shall discuss them at length as my analysis in chapter 2 concludes that Canada lacks adequate creditor protection and a wrongful trading sort of provision could be a viable protective measure. The wrongful trading provisions could therefore serve as a useful model to guide Canada about the mechanics of this remedy.

3.2 Overview of directors' duties at common law

The common law imposes fiduciary duties on directors and a duty of care similar to Canada. The term "fiduciary" is not capable of comprehensive definition but the characteristics of the fiduciary relationship could be identified and the primary duties stated as: someone who undertakes to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.[181] The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core duty has several aspects. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his

[181] *Bristol and West Building Society v Mothew,* [1998] Ch 1 (CA) at 18 [*Bristol*]; *Madden v Dimond,* (1906), 3 WLR 49 12 BCR 80, 1906 CarswellBC 64 (BC CA)

principal.[182] The various obligations of a fiduciary merely reflect different aspects of his core duties of loyalty and fidelity. A "breach of fiduciary obligation, therefore, connotes disloyalty or infidelity. Mere incompetence is not enough. A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty."[183] The remedies for breach of fiduciary duties include damages, compensation, restoration of a company's property, rescission of a transaction or a requirement of a director to account for any profits made as a result. They may also include injunction or declarations for anticipatory breaches.[184]

The liability of a fiduciary for the negligent transaction of his duties is not a separate head of liability but the paradigm of the general duty to act with care imposed by law on those who take it upon themselves to act for or advise others.[185] In *Bristol,*[186] the court noted that although the historical development of the rules of law and equity have in the past caused different labels to be stuck on different manifestations of the duty, in truth the duty of care imposed on trustees, directors, agents and others is the same duty. It arises from the circumstances in which they were acting and not from their status or description. The fact that they have assumed responsibility for the property or affairs of others renders them liable for the careless performance of what they have undertaken to do and not the description of the trade or position which they hold.[187] Thus, at common law, the directors' duty to exercise reasonable care and skill is not specifically a fiduciary duty.[188] The common law remedy for breach of duty of care is damages and compensation for breach of equitable principles. The modern trend is to assimilate the requirements for

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[182] *Bristol, supra* note 181 at 18
[183] *Bristol, supra* note 181 at 18
[184] Geoffrey Morse et al, *Palmer's Company Law: Annotated Guide to the Companies Act 2006*, 1st ed. (London: Sweet & Maxwell, 2007) at 175-176 [Palmer's]
[185] *Bristol, supra* note 181 at 16-17 (The existence of a fiduciary relationship does not mean that every duty owed by a fiduciary to the beneficiary is a fiduciary duty. It has also been held, that the director's duty to exercise care and skill has nothing to do with any position of disadvantage or vulnerability on the part of the company and is not a duty that stems from the requirements of trust and confidence imposed on a fiduciary).
[186] *Bristol, supra* note 181
[187] *Bristol, supra* note 181 at 16-17
[188] *Bristol, supra* note 181 at 17 (although it is a duty actionable both in law and in equity. The common law and equity each developed the duty of care, but they did so independently of each other and the standard of care required is not always the same)

liability for breach of the duty of care in equity and at common law.[189] The common law applies rules of causation, remoteness of damage and measure of damages (tort of negligence) to any breach of the duty of care.

The case of *Re Lee Behrens & Co Ltd*[190] established that directors owe a duty to the company [191] but *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd*[192] (*Multinational Gas*) clarified its nature and content expressly as follows:

> "The directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders. The duties owed by a director include a duty of care, as was recognized by Romer J, in *Re City Equitable Fire Insurance Co. Ltd.,* though as he pointed out the nature and extent of the duty may depend on the nature of the business of the company and on the particular knowledge and experience of the individual director."[193]

That said, there has been a significant corpus of jurisprudence confirming that: "when a company is insolvent or of doubtful insolvency or on the verge of insolvency and it is the creditors' money which is at risk the directors, when carrying out their duty to the company, must consider the interests of the creditors as paramount and take those into account when exercising their discretion."[194] The case law fails to provide how this obligation blends with the traditional duties of directors toward shareholders. The scope

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[189] Paul L Davies, *Gower and Davies: Principles of Modern Company Law*, 8th ed. (London: Sweet & Maxwell, 2008) at 495 [Gower]

[190] *Re Lee Behrens & Co Ltd* [1932] 2 Ch 46 at 49

[191] Bruce Hanton, *International Comparative Legal Guide to: Corporate Governance*, 4th ed. (London: Global Legal Group, 2011) at 1

[192] *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd*, [1983] Ch. 258 CA [*Multinational Gas*]

[193] *Multinational Gas, supra* note 192 at 288 (citation omitted)

[194] *Gwyer, supra* note 9 at 178 (citing *West Mercia Safetywear Ltd v Dodd* (in liq), [1988] BCLC 250 at 252-253 [*West Mercia*] applying the reasoning in *Kinsela v Russell Kinsela Pty Ltd* (in liq), (1986) 4 NSWLR 722 at 730 (CA, NSW); also been applied in the Court of Appeal in *Brady v Brady,* [1988] BCLC 20 at 40 [*Brady*] per Nourse LJ where he stated that the interests of the company in this context are in reality the interests of the existing creditors alone)

of this common law rule[195] is controversial (academics regard this duty as fiduciary and *ex post* in nature[196]) with cases supporting a variety of suggestions but the generally accepted judicial and academic view is that a duty is owed by directors to the company and not to the creditors themselves[197] requiring directors of the insolvent or border line insolvent companies to have regard to the interests of the company's creditors.[198] In contrast, s.214 in the *IA 1986* is a form of creditor protection and covers some of the ground of a duty to creditors at common law. It, however, in effect creates a duty of care owed by the directors to creditors, enforceable by the liquidator, to take all reasonable steps to minimize further loss to the creditors once there is no reasonable prospect of the company avoiding insolvent liquidation.[199]

In *Peoples*, the Canadian SCC basically confirmed that directors owe a duty to the company but not that it involves taking into account creditors' interests when it is in financial difficulty or insolvent. It may be due to the fact that the question of directors taking into account creditors' interests in or near insolvency as part of their duties to the company was not raised in *Peoples*, in which the issue was whether directors owed a direct duty to creditors. There is a possibility that creditors in Canada may raise this issue again in some future litigation framing the issue not in terms of a direct duty but whether it would be a breach of directors' duty to the company if they failed to consider creditors' interests. If this were to happen, the common law position would be that when a company is insolvent or of doubtful insolvency or on the verge of insolvency directors when carrying out their duty to the company must consider the interests of the creditors as paramount. It is not known when that question will be raised but instead of waiting for that moment to arrive isn't it better to get ready by legislating the said common law rule that when a company is insolvent or is in financial distress directors when carrying out

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[195] Commentators have used the word "responsibility", "duty" and "obligation" to refer to this common law rule. I shall use the word "duty" but depending on the context may use "obligation" as well.
[196] Keay, *Responsibilities to Creditors, supra* note 85 at 197
[197] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd,* [1991] 1 AC 187 at 217 PC; *Yukong Line Ltd of Korea v Rendsburg Investments Corporation,* [1998] BCC 870 at 884 [*Yukong*]
[198] *West Mercia, supra* note 194 at 252-253; also Palmer's, *supra* note 184 at 169; See para 3.7 for a discussion on the development of this duty.
[199] Gower, *supra* note 189 at 520

their duty to the company must consider the interests of the creditors as paramount[200] in the Canadian corporate law so that directors are made aware of their common law responsibilities?

3.3 The *CA 2006,* background and scope

The *CA 2006* either restates or amends almost all of the provisions of the English *Companies Act 1985* (*CA 1985*). The *CA 2006* is the product of the most extensive revision of company law since 1856. It culminated from a seven-year consultation by the Company Law Review (CLR), which was set up by the Department of Trade and Industry (DTI). Prior to that, the DTI reviewed selected areas of company law from 1991-1998 including directors' duties. That consultation was itself preceded by substantial work and two reports delivered by the Law Commissions on directors' duties and shareholder remedies.[201] The DTI became the Department for Business, Enterprise and Regulatory Reform (BERR) in 2007 and in 2009 the Department for Business, Innovation and Skills (BIS).[202]

As part of its work, the CLR had to consider how company law should be framed to protect through regulation, where necessary, the interests of those involved with the enterprise, including shareholders, creditors and employees. This question referred to as the 'scope' issue was considered at length, primarily in the context of directors' duties. Len Sealy narrates that this issue gave rise to a competition between pro-stakeholder approaches against pro-shareholder approaches. The "pluralists", in the former group, contended that a statement of directors' duties should oblige directors to have regard to the interests of all 'stakeholders' in the enterprise (and even where appropriate prioritize the interests of some stakeholders ahead of those of the shareholders). The other group favoured retention of a shareholder oriented approach framed in an "inclusive" way so that in assessing what promotes success of the company for the members' benefit,

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[200] See FN 194
[201] LC261, *supra* note 14
[202] UK BIS web site <http://www.bis.gov.uk/> (several consultation reports, papers and other documents are available at its web site, in the search box write company law review it will produce archived documents: Company Law Review/Policies/BIS)

directors take into account the interests of stakeholders (and wider interests, such as the environment) in so far as they believe, in good faith that these factors were relevant (the CLR referred this as "enlightened shareholder value" approach). The CLR reached the conclusion that the "inclusive" pro-shareholder approach was preferable (specifically for the reasons that it would not require any change in the ultimate objective of companies (shareholder wealth maximization), or to reform the fundamentals of directors' duties or to alter the rights of the shareholders to appoint or dismiss directors). The "pluralist" approach posed difficulties in formulation of new principles and their enforcement.[203] It may be kept in mind that the pluralistic view risks leaving directors accountable to none. Someone has to keep an eye on directors' performance and academics agree that shareholders have traditionally performed this function quite well.

In my view, shareholder wealth maximization is the best objective of companies and directors owe fiduciary duties to the shareholders with a view to maximize their wealth subject to wider moral and ethical considerations. This may be perfectly fine when the corporation is solvent and healthy. However, if the corporation is financially distressed or insolvent, then creditors' interest should be paramount. When the company is insolvent, the directors' obligation should be to immediately cease carrying on the business of the company and place it in liquidation if aware that creditor interests are threatened. However, if it is in financial distress only and not insolvent then directors may subject to their discretion continue trading but should be under a duty of care towards creditors when discharging duties to the corporation so as not to take any irresponsible step that may diminish creditors interests in the corporation. I understand it is difficult to pin point with exact precision when the company enters the zone of insolvency or is financially distressed but it is a factual enquiry and directors based on the financial statements, accounts and other relevant indications may develop an understanding about the health of their company. It should not be an excuse that it is difficult to know but serve as an opportunity to be more vigilant and cognizant of the realities of one's business. I am not in favour of extending fiduciary duties to creditors but a positive obligation on directors to consider creditor interests in such a situation is the best course to follow. However,

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[203] Sealy, *supra* note 69 at 302

"considering creditors' interests" does not necessarily mean immediately ceasing business if the company is in financial distress only and could be salvaged. England has done this. They have adopted the approach to obligate directors towards creditors as opposed to imposing fiduciary duties. So far, this model seems to be working fine in England[204] and could potentially work in Canada as well.

The White Paper published on Company Law Reform[205] recognized this concept of "shareholder value" in the following words:

> "Shareholders are the life blood of a company, whatever its size. We want to promote wide participation of shareholders, ensuring that they are informed and involved, as they should be. And we want decisions to be made based on the longer-term view and not just immediate return. We will embed in statute the concept of Enlightened Shareholder Value by making clear that directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers."[206]

This "Enlightened Shareholder Value" approach imposing on directors a duty to promote the success of the company is an innovative balanced approach, which shows England's openness and adaptability to change. With regard to the introduction of a statutory statement of directors' general duties the White Paper on Company Law Reform stated that:

> "The statutory statement of duties will replace existing common law and equitable rules. The duties will be owed to the company, and – as now – only the company will be able to enforce them. (In certain circumstances, the shareholders may be able to bring a derivative action, albeit essentially for the company's benefit). The statement of duties will be drafted in a way, which reflects modern business needs and wider expectations of responsible business behaviour. The CLR proposed that the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to

[204] Keay, *Responsibilities to Creditors, supra* note 85 at 140 (citing a survey by Hicks carried out in 1993 which found that s.214 encouraged directors to be responsible in making decisions in light of insolvency)
[205] UK, Parliament, "Company Law Reform", Cm 6456 (2005) DTI (available online at UK Department of Business Innovation & Skills <http://www.bis.gov.uk/files/file13958.pdf>) (Cm 6456)
[206] Cm 6456, *supra* note 205 at page 5

An interesting aspect of the new provisions is that, though it appears they provide for a stakeholder approach to corporate governance, they basically require directors to act for the benefit of one party only; i.e., the shareholders. The words "the company" in s.170(1) arguably mean "shareholders".[210] The reference to "success of the company" for "the benefit of its members as a whole" in s.172(1) supports this view. The fact that the courts in England have recognized that, in solvency, the company consists of primarily shareholders in the context of directors' duties also bolsters the said reasoning. For example, in *Multinational Gas* the Court of Appeal in discussing directors duties to the company held that: "so long as the company is solvent the shareholders are in substance the company."[211] Similarly, in *Greenhalgh v Arderne Cinemas*[212]*,* in the context of whether a special resolution had been passed bona fide for the benefit of the company, Sir Raymond Evershed, M.R. said: "The phrase, "the company as a whole," does not (at any rate in such a case as the present) mean the company as a commercial entity as distinct from the corporators. It means the corporators as a general body. That is to say, you may take the case of an individual hypothetical member and ask whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit."[213] This applies not only to present members but future members (including the long-term interests of the present members). In a similar context in *Sidebottom v Kershaw Leese and Company Limited,*[214] it was held that: "a corporation is a distinct legal entity. Speaking of the benefit of the company as a whole, one means the benefit of all the shareholders."[215] Thus, in a solvent company, the proprietary interests of the shareholders

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(b) to the duty in section 176 (duty not to accept benefits from third parties) as regards things done or omitted by him before he ceased to be a director.
To that extent those duties apply to a former director as to a director, subject to any necessary adaptations.
(3) The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director.
(4) The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties."

[210] Sealy, *supra* note 69 at 301
[211] *Multinational Gas, supra* note 192 at 288
[212] *Greenhalgh v Arderne Cinemas,* [1951] Ch 286 [*Greenhalgh*]
[213] *Greenhalgh, supra* note 212 at 291
[214] *Sidebottom v Kershaw Leese and Company Limited*, [1920] 1 Ch 154 [*Sidebottom*]
[215] *Sidebottom, supra* note 214 at 157

are considered as the company when the issue of the duty of directors arises under the English company law subject to the requirement to take into account the interests of other constituents, creditors being one.

The following seven common law and equitable duties of directors are codified and set out in ss.171 to 177 of the *CA 2006*:

(i) Duty to act within powers (s.171)
(ii) Duty to promote the success of the company (s.172)
(iii) Duty to exercise independent judgment (s.173)
(iv) Duty to exercise reasonable care, skill and diligence (s.174)
(v) Duty to avoid conflicts of interest (s.175)
(vi) Duty not to access benefits from third parties (s.176)
(vii) Duty to declare interest in a proposed or existing transaction or arrangement (ss.177 and 182)

Section 170(3) clarifies two things. First, it states that the general duties are so drafted as to reflect the case law in which the equitable and common law duties governing directors was developed. Secondly, it states that the codified version replaces those principles. Section 170(3) is supplemented by s.170(4) which directs the court to interpret and apply the codified duties to the pre-existing case law. Commentators are of the view that reading s.170(3) and s.170(4) together considerable doubt exists over the extent the codified duties replace or replicate the pre-existing duties.[216] This uncertainty has mainly arisen because the statutory language is different from the judicial pronouncement of the same in the case law. It is clear that under this new law claims for breach of duty by a director will need to conform to one or more of the above stated duties. That said s.172(3) displaces those duties when the company is insolvent.

The remedies available for breach of fiduciary duties have not been codified but s.178(1)

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[216] Professor John Birds, ed. *Annotated Companies Legislation*, 2nd ed. (Oxford University Press, 2012) at para 10.170.02 (example omitted) [Birds]

states that the same consequences and remedies as are currently available should apply to the statutory general duties. A breach of any general duty (except the duty of care) is enforceable as breach of fiduciary duty on behalf of the company by the board of directors, a liquidator or by a derivative action. A derivative claim may be brought under Part 11 of the *CA 2006* against a director of a company for breach of the duty of care. A director is not allowed any exemption to any extent from any liability that would attach to him in connection with any negligence, default or breach of duty.[217] Any such provision whether contained in the company's articles or in any contract with the company is considered void.[218]

3.5 Directors fiduciary duties to creditors under the *CA 2006*

Under the English companies law, a director does not owe a direct fiduciary duty towards a creditor. Nor is a creditor entitled to sue for breach of the fiduciary duty owed by the director to the company.[219] However, in keeping with the trends in the law of insolvency and specifically in relation to the concept of "wrongful trading"[220], a judge may say that the directors of a distressed company must have regard to the interests of the company's creditors not because any duty directly owed to the creditors has come into existence but because it is the creditors' position in the company's liquidation which affects the directors' acts.[221] The only duty of the directors that the English companies law recognizes is that owed to the company as confirmed by *Yukong Lines Ltd of Korea v Rendsburg Investments Corporation,*[222] (*Yukong*) wherein Toulson J. clearly rejected that a direct fiduciary duty is owed to creditors.[223] His Lordship stated that where a director of an insolvent company acts in breach of his duty to the company by transferring assets of the company in disregard of the interests of its creditor or creditors, under the English law he is answerable through the scheme which Parliament has provided. His Lordship

[217] Section 232 of the *CA 2006*
[218] This is to be in direct contrast with the *Delaware General Corporate Law* under which directors' exculpation of liability is permissible.
[219] *Yukong, supra* note 197 at 884
[220] See para 3.8 below
[221] Sealy, *supra* note 69 at 307 (citation omitted)
[222] *Yukong, supra* note 197
[223] *Yukong, supra* note 197 at 884

confirmed that a director does not owe a direct fiduciary duty towards an individual creditor nor is an individual creditor entitled to sue for breach of fiduciary duty owed by the director to the company.[224] Thus, it is only indirectly, through a liquidator acting on behalf of the company, that the creditors' interests are represented and judicial statements that directors are obliged to have regard to the interests of their company's creditors are made in the context just described.[225]

The fact that directors do not owe a direct fiduciary duty towards creditors but have an indirect obligation to consider creditors interests in the period leading up to insolvency is strengthened by reading s.172[226] of the *CA 2006* wherein a new duty to promote the success of the company for the benefit of members as a whole has been introduced. However, s.172(3) specifically states that this duty is subject to any "enactment" or "rule of law" requiring directors in certain circumstances to consider or act in the interests of creditors of the company. The reference to any "rule of law" reflects the trend found in modern case law that when the company is insolvent or on the verge of insolvency, the interests of creditors supersede those of shareholders with the consequence that the focus of the duty changes accordingly.[227] The word "enactment"[228] refers to the provisions of the *IA 1986.* The most notable provision under this enactment is wrongful trading which provides that a liquidator of a company in insolvent liquidation could apply to the court

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[224] *Yukong, supra* note 197 at 884
[225] Sealy, *supra* note 69 at 307
[226] "**Section 172. Duty to promote the success of the company (**derived from the *CA 1985*, s.309(1); sub-ss (2), (3) are new)
(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
(a) The likely consequences of any decision in the long term,
(b) The interests of the company's employees,
(c) The need to foster the company's business relationships with suppliers, customers and others,
(d) The impact of the company's operations on the community and the environment,
(e) The desirability of the company maintaining a reputation for high standards of business conduct, and
(f) The need to act fairly as between members of the company.
(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company."
[227] Birds, *supra* note 216 at para 10.172.06 (examples omitted); Also see para 3.7 below
[228] Section 1293 of *CA 2006* defines meaning of "enactment" as *inter alia* "an enactment contained in subordinate legislation within the meaning of the *Interpretation Act 1978*.

to have a person who is or has been a director of the company declared personally liable to make such contribution to the company's assets as the court thinks proper for the benefit of the unsecured creditors.[229] Thus, by preserving these two, the *CA 2006* has adopted an indirect approach to protect creditor's interests.[230] With regard to the common law duties on creditors, operating before s.214 comes into play and preserved by s.172(3), academics have claimed that the legislature has remitted those to the courts as a matter of common law to decide how far it should be developed to supplement s.214 of the *IA 1986.*[231]

3.6 Duty of care

The duty of care is designed to fight the shirking of directors.[232] It originates from the common law and is codified under s.174[233] of the *CA 2006*. The common law formulation of the duty of care is similar in both Canada and England (though the language in the statutes differs). Both countries, however, have given statutory effect to the modern judicial stance taken towards the determination of the standard of care expected of directors by elevating it to an objective standard. The duty however is owed to the company in England with directors given an indirect obligation to consider creditor interests in insolvency. In Canada, the situation is not so clear with *Peoples* extending a duty of care to creditors without explaining how it will be enforced. The said decision is contentious because directors owe no duty of care to creditors at common law.[234] This supports the need in Canada of a substantive wrongful trading kind of provision which, as I explain above, is in effect a duty of care but an indirect one.

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[229] Birds, *supra* note 216 at para 10.172.08
[230] See para 3.7 below
[231] Gower, *supra* note 189 at 521
[232] Andrew Keay, *Directors' Duties* (Jordans, 2009) at 173 [Keay, *Directors' Duties*]
[233] **Section 174. Duty to exercise reasonable care, skill and diligence**
"(1) A director of a company must exercise reasonable care, skill and diligence.
(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
(b) the general knowledge, skill and experience that the director has."
[234] See more analysis under chapter 5

At common law, directors owe a duty of care to their companies in the performance of their functions. The duty has been described as one in tort rather than one in contract arising from a director's voluntary assumption of responsibility for a company's property and affairs.[235] Falling below the standard, where loss results, it exposes the director in question to an action in negligence by the company. The common law judged directors according to their own personal skills, knowledge, abilities and capabilities and they were not expected to have any particular business skill or judgment.[236] The real developments in this law came with cases such as *Norman v Theodore Goddard*[237] wherein Hoffmann J. implicitly rejected the subjective approach taken towards the assessment of directors conduct in the old case law and accepted that the common law duty was accurately set out in s.214(4) of the *IA 1986*. Two years later, in *Re D'Jan of London Ltd,*[238] Hoffmann L.J. held that the duty of care of a director is accurately set out in s.214(4) and that it was the conduct of "... a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has."[239] In *Bishopsgate Investment Management Ltd (in liq) v Maxwell,*[240] (*Bishopsgat*e) the same judge suggested, obiter that the time has now come for a more objective approach. He observed that: "[I]n the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance ... Even so, the existence of a duty to participate must depend upon how the particular business is organized and the part which the director could be reasonably expected to play."[241]

Section 174 in the *CA 2006* is modeled on s.214 of the *IA 1986*. Thus, it aligns the

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[235] *Henderson v Merrett Syndicates Ltd.,* [1994] 3 WLR 761, 799, per Lord Browne-Wilkinson; [1994] 3 All ER 506 at 541
[236] *Peoples, supra* note 10 at para 59
[237] *Norman v Theodore Goddard*, [1991] BCLC 1028 [*Norman*]
[238] *Re D'Jan of London Ltd.,* [1993] BCC 646 [*D'Jan*]
[239] *D'Jan, supra* note 238 at 648
[240] *Bishopsgate Investment Management Ltd. (in liq) v Maxwell* (No.2), [1993] BCLC 1282 (CA) [*Bishopsgate*]
[241] *Bishopsgate, supra* note 240 at 1285

applicable standards under both statutes. Halsbury's states that the wording of s.214(2) of the *IA 1986* is adopted in s.174(2) of the *CA 2006*, as a gloss on the duty of directors under s.174(1) to exercise reasonable care, skill and diligence.[242] Under the new provision, a director owes a duty to the company to exercise the same standard of care, skill and diligence that would be exercised by a reasonably diligent person with:

(i) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as the director in relation to that company;
(ii) The general knowledge, skill and experience that the director actually has.[243]

Even though the duty of care is owed to the company (as it falls within the general duties specified under ss.171 to 177)), s.178(1)(2) clarifies that it is not fiduciary in nature and is not enforceable as such.[244] The fact that the duty is not considered fiduciary in nature and is not enforceable as such, in my view, means that directors are not required to maintain the highest standard of care in the management of the company that is imposed by equity and law upon a "fiduciary" with respect to the standard of loyalty. The drafting of this provision is somewhat confusing but, when reading s.178(2) with 178(1), it is clear that the consequences of a breach of duty are the same as would apply at common law and so the consequences for breach of the duty of care are the same as for negligence i.e., damages and compensation. The fact that the duty of care is not fiduciary in nature arguably is reflected in the indirect approach that is adopted for recognizing creditor interests in the company via wrongful trading as creditors could only enforce these rights through a liquidator. It is difficult to interpret this provision in any other manner considering s.170(4) expressly provides that the general duties shall be interpreted and applied in the same way as corresponding common law rules and equitable principles and

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[242] Halsbury's Laws of England, vol 14, *Companies*, 5th ed. (LexisNexis, 2009) para 545 at FN10 [Halsbury's England]
[243] Sealy, *supra* note 69 at 331
[244] **Section 178. Civil consequences of breach of general duties**
"(1) The consequences of breach (or threatened breach) of sections 171 to 177 are the same as would apply if the corresponding common law rule or equitable principle applied.
(2) The duties in those sections (with the exception of section 174 (duty to exercise reasonable care, skill and diligence)) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors."

at common law directors owe no direct duties to creditors, even though they are under an obligation to act in the interests of creditors when carrying out their duties to the company when it is insolvent or near it. But academic and judicial opinion regards that as indirect only.[245]

A breach of the duty of care may possibly expose the concerned director to disqualification under the *CDDA 1986.*[246] A company's directors are not trustees for creditors of the company even to the ones to whom the company stands in a fiduciary relationship.[247] A fiduciary relationship could only arise either contractually or by implication of law.[248] The confidence induced by undertaking any service for another is a sufficient legal consideration to create a duty in the performance of it.[249] The creditors except as holders of security on any property of the company and for purposes of realizing their security are not entitled to interfere with the company or its affairs and have no remedy against any director for negligence in the conduct of business or for breach of contract by the company. However the rules making the directors liable for misfeasance or wrongful or fraudulent trading could be invoked for payment to creditors.[250] The wrongful trading and fraudulent trading provisions are discussed at length in the following parts of this chapter. It is odd that, in Canada, the SCC has extended a duty of care to creditors when, under the common law, directors' duties are owed to the corporation and not to the creditors. It is only in the situation of insolvency or near it that an indirect duty to the creditors arises. England has given legal protection to creditors in accordance with the common law position via wrongful trading provisions. Canada should consider that as well.

There is not much case law challenging directors for negligent mismanagement, which according to the literature, could be due to the fact that at the common law such an

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[245] See para 3.7 below regarding development of this duty
[246] See para 3.11 below
[247] Halsbury's England, *supra* note 242 para 590 (referring to directors common law duty to consider or act in the interests of creditors when the corporation is insolvent or near it)
[248] *Bath v Standard Land Company Limited*, [1911] 1 Ch 618 at 642 [*Bath*]
[249] *Bath*, *supra* note 248 at 643
[250] Halsbury's England, *supra* note 242 para 590 at FN 8 (under specific provisions like s.212 (misfeasance) or if conditions met s.214 or 213 of *IA 1986*)

allegation could not form the basis of a derivative action (though negligence now falls within the scope of the derivative claim placed on a statutory footing by Part 11 of the *CA 2006*).[251] Furthermore, petitions brought under s.994 (the unfair prejudice remedy) routinely allege mismanagement.[252] Arguably, s.214 contributed to some of the case law in connection with insolvent mismanagement.

In England, the CLR rejected the business judgment rule as a formal requirement of the English law in dealing with concerns that *ex post* review by courts of directors' decisions on negligence grounds if not carefully handled may slow down the process of decision-making by directors and make them risk averse.[253] It stated that:

> "Directors are employed to take risks, often under severe time pressures which prevent the fullest examination of all the relevant factors. Some of these risks will not pay off. The directors' key skill is one of balancing the risk and time factors, recognizing that their company's success and failure will depend on their not being unduly cautious as well as avoiding fool-hardiness. What risks are appropriate will depend on a multitude of factors, including the ethos of the company and the character of its business and markets. There may be a danger that the courts will apply hindsight in such cases and reach unduly harsh conclusions based on an alleged absence of care and sill. This is the argument for creating a specific business judgment defence which is part of US case law and which has been recently introduced in a legislative form in Australia."[254]

Hoping that the courts applying the new section on the duty of care would follow a similar approach, the above paragraph from the CLR continues to state:

> "However our courts have shown a proper reluctance to enter into the merits of commercial decisions; there are major difficulties in drafting such a provision which would add complexity and is likely to be inflexible and unfair, being too harsh in some cases and allowing too much leeway in others. *The principle as drafted leaves room for the courts to develop this approach*. We also propose to retain in slightly more generous form the existing provision enabling the courts to relieve directors of liability. We therefore oppose a legislative business

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[251] Birds, *supra* note 216 at para 10.174.04
[252] Birds, *supra* note 216 at para 10.174.04
[253] Davies, *supra* note 4 at 151
[254] CLR, Modern company law for a competitive economy: developing the framework, URN 00/656, (2000) para 3.70 (at BIS UK web-site, *supra* note 202) [CLR, Modern Company Law]

judgment rule."[255] (emphasis added)

The two paragraphs imply that a business judgment rule exists in England though not in a legislated form. Its nature and exact form is not very clear and there is not much in the literature about its role. That said it might be said that English courts, like their counterparts in Delaware and Canada are reluctant to enter into the merits of commercial decisions. Also, England has expressly incorporated s.214 and certain provisions under the *CDDA 1986*[256] that require the courts to evaluate the quality of management decisions. These provisions have exact demands of performance. These statutory provisions have simply increased the number of areas that are not treated as falling within pure unreviewable management decision-making powers.[257] Also, England has inserted s.1157[258] which arguably thwarts the business judgment rule as, under that provision, the court is bound to review directors' decisions to pardon them for negligence or breaches of duty to the company. Thus, the mechanics for creditor protection and enforcement techniques are varied under the English legislation.

To end this chapter, I would like to say that the formulation of the duties even with the adoption of "enlightened shareholder value" keeps shareholders the primary focus of directors' duties in England. In my view, Canada arguably also has a shareholder primacy view of its corporate law. In *BCE* the SCC stated that directors fiduciary duty is to act in the best interests of the corporation and in considering what is in the best interests of the corporation they *may* look to the interests of *inter alia* shareholders, employees creditors, government, environment and the consumers to inform their decisions (emphasis added).[259] The directors however are not obligated to look to those interests. In a solvent corporation in my view the economic interest of shareholders aligns with the interest of the corporation so it may not be wrong to assume that Canadian corporate law has a shareholder centric approach. Also, it is worth remembering that under English common

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[255] CLR, Modern Company Law, *supra* note 254 at para 3.69
[256] See para 3.11 below
[257] Peter Loose, Michael Griffiths & David Impey, *The Company Director Powers, Duties and Liabilities*, 9th ed. (Jordans, 2007) at para 6.171 [Peter Loose]
[258] Discussed later in para 3.9 below at length
[259] *BCE, supra* note 11 at para 38 & 40

law that Canada also follows it is stated that "so long as the company is solvent the shareholders are in substance the company."[260] Thus, in my view both jurisdictions share similar values though statutory language, the scope and content of directors' duties is much wider in England. The drafting of the duty of care is confusing in England and in Canada the SCC's rendition of that duty is confusing. The statutory formulation of the business judgment rule was considered unnecessary by the CLR. Under the English common law, when a company is insolvent or on the verge of insolvency and it is the creditors' money that is at risk, the directors, when carrying out their duty to the company, must consider the interests of the creditors as paramount. The scope of this rule is controversial but the generally accepted view is that directors' owe a fiduciary duty to the company and not to creditors directly. Section 214 of the *IA 1986* is a mechanism of creditor protection. The *CA 2006* has adopted an indirect approach to preserve creditors' interests under the *IA 1986* (the most notable provision in that statute is s.214 viz., wrongful trading). Thus, with its enlightened shareholder approach, England has not abandoned creditors' interests. Contrary to England, Canadian corporate law or its various insolvency regimes do not specifically prohibit insolvent or wrongful trading and there is no clear liability on directors who persist in trading even when a corporation is hopelessly insolvent.[261] In Part II of this chapter, I shall accordingly examine the role and effect of the wrongful trading provisions in protecting creditor interests in England and its potential for import to Canada.

[260] *Multinational Gas, supra* note 192 at 288
[261] McGuinness, *supra* note 53 at para 13.190

II. WRONGFUL TRADING

3.7 Development of the duty to consider interests of creditors

I said in Part I that, when a company is insolvent or on the verge of insolvency, directors are governed by an obligation at common law to act in the interests of creditors when carrying out their duties to the company. I also said that the acceptable academic and judicial view is that this obligation is not direct. I, however, have uncovered conflicting dicta that might support a direct duty to creditors primarily in the context of winding up claims for breach of fiduciary duties or misfeasance.[262] In this Part, I will explain why, despite that, I agree with the widely-accepted view that the duty is not direct. I start with the case of *Winkworth v Edward Baron Development Co Ltd and Others*[263] in which the House of Lords allowed the appellant legal mortgagee Mr. Winkworth's appeal seeking possession of the matrimonial home mortgaged by the company in which Mr and Mrs Wing both were directors and shareholders. The respondent husband arranged for company to mortgage property without the knowledge of his wife by forging her signatures. The wife claimed to hold an adverse equitable interest in the property because she had contributed to reducing the overdraft of the company, which she claimed, gave her priority over secured and unsecured creditors of the company. The shares in the company and the matrimonial home were bought by using the company's money. The matrimonial home was owned by the company. Lord Templeman said that: "by using the company's money to purchase their shares and for other personal expenditures, the husband and wife as directors had been in breach of their duties to the company and its creditors to ensure that company property was not dissipated to the prejudice of the company's creditors. In these circumstances, and where the husband and wife had failed to maintain the solvency of the company, equity would not treat the payment of the

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[262] Misfeasance is the customary expression for breach by directors of duties owed to the company, one of which is their common law duty to exercise an appropriate level of care and skill in the performance of their functions. Therefore a misfeasance claim may be a claim at common law. (taken from *Re Continental Assurance Company of London plc. (In liquidation) (No. 4),* [2007] 2 BCLC 287 at 441 (Ch D) (*sub nom Singer v Beckett*) [*Continental Assurance*]; Misfeasance proceedings may be brought by liquidator to seek remedy for individual creditors under s. 212 of *IA 1986* for which remedy is damages.

[263] *Winkworth, supra note* 9

£8,600 as conferring on the wife an interest ranking in priority to the creditors." [264] His Lordship further held that these breaches would not have mattered if respondents had maintained the solvency of the company and paid its creditors.[265]

Interestingly, this reasoning could not be found in other cases. In *Multinational Gas*[266]*,* Dillon L.JJ in the Court of Appeal seemed to suggest that English courts would be reluctant to require creditors' interests to be considered by directors. In his Lordship's words: "The directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future . . ."[267]. Similarly, in *Re Continental Assurance Co of London plc.,*[268] (*Continental Assurance plc.*), Judge Park of the Chancery Division confirmed that: "the directors' duty, for alleged breach of conduct amounting to misfeasance was owed to the company, not to its shareholders or creditors".[269]

The decision in *West Mercia Safetywear Ltd (in Liquidation) v Dodd and Another*[270] is instructive on the issue of the duty of care. The case concerned West Mercia, a wholly owned subsidiary of A.J Dodd & Co Ltd (Dodd Co). Both companies had a common director, Dodd, and both banked with Lloyd's bank. West Merica's account was on credit. Dodd Co's account was also overdrawn. Dodd had guaranteed Dodd Co's liability to the bank. In 1984, both companies became insolvent. An accountant (later appointed liquidator) was called who advised Dodd not to operate West Marcia's bank account any more. Despite that advice Dodd instructed the bank to transfer £4000 from West Merica's account to that of Dodd Co to reduce Dodd's personal liability under his bank guarantee. The liquidator subsequently brought proceedings against Dodd for breach of his duty to consider the interests of creditors of West Mercia. The Court of Appeal found for the

[264] *Winkworth, supra* note 9 at 118
[265] *Winkworth, supra* note 9 at 118
[266] *Multinational Gas, supra* note 192
[267] *Multinational Gas*, *supra* note 192 at 288
[268] *Continental Assurance*, *supra* note 262
[269] *Continental Assurance, supra* note 262 at 294
[270] *West Mercia, supra* note 194

liquidator. Dillon LJ distinguished his earlier reasoning in *Multinational Gas*[271] by stating that, in that case, the relevant company was “amptly solvent” and the directors acted in good faith. In this case, the company was “insolvent” to the knowledge of the directors when the funds in question were transferred and Dodd, in fraud of the creditors, made that transfer. Later decisions have however held that the interests of creditors could “intrude” even when a company may not strictly be insolvent.[272] Also, in *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*[273]*,* it was held that: “where a company is insolvent or of doubtful solvency or on the verge of insolvency and it is the creditor’s money which is at risk the directors when carrying out their duty to the company must consider the interests of the creditors as paramount and take those into account when exercising their discretion”.[274] The case law fails to lay down precisely how close to insolvency the company must be before any duty to creditors arise.

Andrew Keay is of the opinion that the duty owed to creditors by the directors is not a direct duty and technically is not a duty to creditors. The duty is an indirect one in that it is owed not to creditors but to the company to consider creditors’ interests. He opines that the duty is mediated through the company. Keay has offered three arguments against the direct duty. First, a duty to creditors could lead to double recovery in that both the creditors would sue individually and a liquidator would sue on behalf of the company if it is taken into liquidation. Secondly, permitting creditors to recover under a direct duty could damage the *pari passu* principle (like cases to be treated alike), which is the foremost principle of insolvency law. Thirdly, providing for an indirect duty means that the collective procedure of liquidation (i.e., creditors forfeit their respective individual rights to take action to enforce their claims and are given in exchange a right to prove in the liquidation) would be preserved.[275] Academic opinion generally is that the duty is an indirect one, and the *obiter* comments of Lord Templeman in *Winkworth* are incorrect.[276] The academic opinion seems to resonate with the decision in the later English case of

[271] *Multinational Gas, supra* note 192
[272] *GHLM Trading Ltd v Maroo,* [2012] WL 14742 at para 165, [2012] All ER D (172) Jan [*GHLM*]
[273] *Gwyer, supra* note 9
[274] *Gwyer, supra* note 9 at 178
[275] Andrew Keay, “Another way of skinning a cat: enforcing directors' duties for the benefit of creditors”, (2004) 17:1 Insolv Int 1-9 at 3 [Keay, *“*skinning a cat*”*]
[276] Keay, *“*skinning a cat*”*, *supra* note 275 at 3

Yukong Lines Ltd of Korea v Rendsburg Investments Corporation[277] wherein it was confirmed that a director does not owe a direct fiduciary duty towards an individual creditor nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company.[278] Further support may be drawn from this argument that, in the majority of Commonwealth jurisdictions that have accepted the concept of an indirect duty only[279] any action to enforce the duty is usually undertaken on behalf of the company by its liquidator. That said, there still are some academics who interpret it as some type of duty that is accepted by shareholders in the *ex ante* bargain.[280] However, based upon this analysis and review of cases, my view is that the duty is not direct.

This view is further strengthened by a perusal of s.172 of the *CA 2006* which shows Parliament also desired to keep the duty indirect. The insertion of s.172(3) in the *CA 2006* is specifically aimed at indirect extension of directors' duty to the company's creditors. The word "enactment" in s.172(3), as I discussed earlier, is in reference to the provisions of the *IA 1986.*[281] The most important provisions under that enactment that makes the directors liable to creditors include "wrongful trading" (s.214[282]) and

[277] *Yukong, supra* note 197
[278] *Yukong, supra* note 197 at 884 (see my discussion under 3.5)
[279] Keay,"skinning a cat", *supra* note 275 at 3
[280] Referring to Rizwaan J Mokal, "An agency cost analysis of the wrongful trading provisions: redistribution, perverse" (2000) 59:2 Cambridge L J 335-369
[281] <http://www.legislation.gov.uk/ukpga/1986/45/contents>; also see para 3.5 above
[282] **Section 214. Wrongful trading:** (from the *Insolvency Act 1985*, ss 12(9), 15(1)–(5), (7), Sch 9, para 4)
"(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that, that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.
(2) This subsection applies in relation to a person if:
(a) The company has gone into insolvent liquidation,
(b) At some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
(c) That person was a director of the company at that time;
but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.
(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimizing the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into solvent liquidation) he ought to have taken.

"fraudulent trading" (s.213[283]). The wrongful trading provision is aimed at incompetent directors (it in effect creates a duty of care to creditors. It imposes the same standard (gross negligence) but defines negligence in terms of creditors' interests. It may be asked if Canadian courts may ever find directors liable to creditors on that basis? I would say it is possible after all SCC in *Peoples* extended a duty of care to creditors. It is another issue that the said extension has been widely criticized for the reasons discussed in para 2.4 above) rather than those suspected of dishonesty which is dealt with under the fraudulent trading provision. The wrongful trading provision is restricted to insolvent companies whereas the fraudulent trading provision is not. Section 214 of the *IA 1986* captures the essence of the Cork Committee's recommendations.[284] This section has sometimes been said to preclude the need for any duty to creditors at common law.[285]

It is to be noted that the English law does not provide for a duty of the directors or the shareholders to file a petition in bankruptcy if the company is formally bankrupt. Instead, the provisions on fraudulent trading (s.213 *IA 1986*) and on wrongful trading (s.214 *IA 1986*) aim at inducing the directors to choose a future course of action with respect to the company that would minimize the losses of existing creditors. The duty under s.214[286] comes into play "when there is no reasonable prospect that the company would avoid

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(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both:
(a) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
(b) The general knowledge, skill and experience that that director has.
(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions, which he does not carry out but which have been entrusted to him.
(6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.
(7) In this section "director" includes a shadow director.
(8) This section is without prejudice to section 213."

[283] I have discussed it at length in part III, chapter 3

[284] Cork Report, *supra* note 6 chapter 44

[285] Donna W McKenzie-Skene, "Directors' Duty of a Financially Distressed Company: A perspective from across the pond" (2007) 1:2 J Bus & Tech L 499 at 522

[286] It is not clear if s.214 imposes any specific duty upon a director. In *Re Produce Marketing Consortium (In Liquidation) Ltd,* [1989] 5 BCC 399 at 400 (Ch D) [*Produce Marketing No.1*] the judge was willing to accept that a duty did exist in the shape of a director's obligations in relation to which s.214 imposes a sanction for not having discharged it in the way which the law requires. However he did not conclude that point. That said some commentators have called it duty while others have referred to it as obligation. I shall use the word 'duty' in this thesis but depending on the context may refer to it as 'obligation'.

going into insolvent liquidation," i.e., even before formal insolvency. This duty does not serve as a basis for individual creditors' claims against directors but opens up the possibility of challenges at common law, on creditors' behalf by a liquidator.[287] Moreover, in the vicinity of insolvency, directors are governed by an obligation at common law, as discussed above, to act in the interest of the creditors as a group when carrying out their duties to the company.[288]

Thus, it may be concluded that, in normal circumstances where the company is financially stable, the primary duty of directors under the English Companies law is to promote the success of the company with reference to the interests of its shareholders as a whole and having regard to various specified factors (referred to as "enlightened shareholder value") but, when a company is insolvent or in financial distress, the directors discharge their duties by reference to the best interests of the creditors of the company. It may not always be clearly known as to when a company is in the "zone of insolvency" or "near insolvency" or "on the verge of insolvency". There are no tests or rules laid down defining these terms. These term remain elusive and it may therefore be difficult for directors to know when exactly their duties to creditors start at the common law. This has been an issue in all jurisdictions under my study.[289] In Canada and the US as well as England, there are no criteria that could determine that a company is in the zone that these terms represent. In fact, the SCC in a recent decision has altogether rejected such terms because in its opinion it is incapable of any definition and of no legal meaning.[290] Section 214 lays down a test to determine insolvent liquidation but arguably by the time a company is insolvent it has already passed through this "zone of insolvency" for which apparently there are no tests and this affects creditors directly[291]. I now start my analysis of this provision which may be quite descriptive as I would like to

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[287] Peter O Mulbert, "A synthetic view of different concepts of creditor protection, or: a high-level framework for corporate creditor protection", (2006) 7:1 E B O R 357 at 400-401 [Mulbert]
[288] Mulbert, *supra* note 287 at 401 (citations omitted)
[289] *Peoples SCC, supra* note 10 at para 46 (it was stated that nebulous "vicinity of insolvency" is incapable of definition and has no legal meaning)*; Gheewalla (Del Sup Ct), supra* note 9 at 98 FN 20 (recognizing that Delaware courts have not been able to set forth precise definition of the "zone of insolvency" due to difficulties in identifying the said zone)
[290] *Peoples SCC, supra* note 10 at para 46
[291] See discussion on the tests under para 3.10 below

discuss all important aspects of this provision in order to fully illustrate the potential this provision has to offer to Canada.

3.8 Determining "wrongful trading"[292]

The doctrine of "wrongful trading" is dealt with in s.214 of the *IA 1986.* Section 214 empowers a court to declare that directors (or former directors[293]) are liable to contribute to the assets of a company if they have continued trading when it was clear that the company could not avoid insolvent liquidation. Section 214 requires that the court use the following conditions in determining wrongful trading by a director that:

(a) The company is in insolvent liquidation.
(b) During some time before the commencement of the winding up of the company did the director know or ought to have concluded that there was no reasonable prospect of the company avoiding an insolvent liquidation? (s.214(2)) [If no, then there isn't wrongful trading by that director]
(c) If yes, following the time he did become aware (or ought to have become aware) that there was no reasonable prospect that the company would avoid going into an insolvent liquidation did he take every step to minimize the potential loss to the company's creditors, as he ought to have taken? (s.214(3)) [If yes, then the court will not make an order against the director].[294]

In order to satisfy the above conditions, the court is guided by a subjective and objective

[292] The words "wrongful trading" are not defined but the conduct that constitutes it is clear from reading the provision. Specifically it includes the paying of overgenerous dividends, selling company assets at an undervalue and the payment of excessive remuneration to directors as well as the incurring of liabilities when the directors knew or ought to have known that the company was likely not to be able to satisfy those liabilities and existing liabilities. It includes incompetence, ignorance and indifference as well as conscious wrongdoing (Keay, *Responsibilities to Creditors*, *supra* note 85 at 84 & 94), In *Continental Assurance, supra* note 262 at 296, Park J. stressed that "[t]he continued trading albeit wrongful has to make the company's position worse, so that it has less money available to pay creditors, rather than leave the company's position at the same level". Thus, the section could be read widely.
[293] *Continental Assurance, supra* note 262 at 356
[294] Bruce Hanton, *International Comparative Legal Guide to: Corporate Governance*, 4th ed. (London: Global Legal Group, 2011) at 2

test in that the facts which a director of a company ought to know or ascertain, the conclusions which he ought to have reached and the steps which he ought to have taken are those which would be known or ascertained or taken by a reasonably diligent person having, on the one hand, the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company and, on the other, the general knowledge, skill and experience that the relevant director has. The later introduces a subjective element in the test which is a departure from the original rather strict proposal of the Cork Report who proposed only an objective test of an ordinary reasonable person for wrongful trading.[295]

The present provision, however, judges a director by a dual objective/subjective test and he has to attain the higher of the standards set out by the tests. A director has to meet the standard of a reasonable person acting in the same capacity as him as well as use his personal knowledge, skill and experience (e.g., an experienced and well qualified director may be liable under s.214 if he does not use his experience and knowledge in managing the business and affairs of the company). Similarly, where a director uses his experience and knowledge but does not act reasonably (probably due to lack of practical experience), he may still be liable (lack of expertise being no excuse). The director must fulfill both tests to avoid liability.[296] The underlying reason behind this test is that inexperienced and incompetent directors may not hide behind their inexperience and incompetence nor may experienced directors escape liability by arguing that while they did not act according to their own standards they did everything that an average person would have done.[297]

The case of *Re Produce Marketing Consortium (In Liquidation) Ltd., (No.2)*[298] (*Produce Marketing Ltd. (No.2)*) is the first that came for judgment under this section and it provides valuable insights on the working of s.214 of the *IA 1986.* The facts of this case are common occurrences.

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[295] Cork Report, *supra* note 6 at para 1783
[296] Keay, *Responsibilities to Creditors*, *supra* note 85 at 89
[297] *Keay, Responsibilities to Creditors, supra* note 85 at 89
[298] *Re Produce Marketing Consortium (In Liquidation) Ltd, (No.2)* [1989] 5 BCC 569 (Ch D) [*Produce Marketing No.2*]

Produce Marketing Consortium Ltd. (PMC)[299] was engaged in import of fruits on commission at the rate of 3.5%[300]. It had two directors at the relevant time: Murphy and David. PMC had an authorized share capital of £20000.00, £1 per share of which £12,600.00 were issued half of which were owned by David. Murphy joined the company at the outset as a general accounts clerk. He had no professional accountancy qualifications but was an experienced bookkeeper. He became the director in 1974 but was not a shareholder. PMC's financial difficulties were apparent since 1980. In 1984, PMC was officially operating on bank overdraft and its liabilities exceeded its assets. Its position deteriorated further by the summer of 1986 as the bank's overdraft limit of £75000 was frequently exceeded between Jan and July of 1986. The 1984–85 and the 1985–86 accounts contained directors' reports which included a statement that, at the balance sheet date, the company was insolvent but the directors were confident that if the company continued to trade, it would be able to meet its liabilities. The two accounts were signed February 5 and 12, 1987 respectively. The company had a history of filing its accounts late. The accounts of 1984-85 were filed over six months beyond the time limit of ten months for private companies required by s.242 of the *CA 1985*. The auditor warned the directors of possible liability for fraudulent trading for continuation of business and incurring debt despite knowledge that there was no reasonable prospect of repaying those debts. Although there was a decrease in PMC's overdraft with its bank during 1986/87, this was to a large extent financed by PMC's increased indebtedness to its principal supplier of fruit. In November 1986, the bank started to return cheques unpaid. PMC went into a creditors' voluntary liquidation on October 2, 1987. The liquidator sought an order that Murphy and David should be held liable under s.214 of the *IA 1986* to contribute £107,946 to the assets of PMC. The court carried out an exhaustive analysis laying down the following important principles.

The first issue before the court was whether, at "some time" after 27 April 1986 and before 2 October 1987, Murphy and David knew or ought to have concluded that there was no "reasonable prospect" that the company would avoid going into insolvent

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[299] A private company incorporated in 1964

[300] So the ratio of its turnover and profits was readily calculable

liquidation. The liquidator argued that they should have so concluded at the earliest in July 1986. Murphy and David agreed that this had to be evaluated by the standards postulated by s.214(4), which requires that the facts which Murphy and David ought to have known or ascertained and the conclusions that they ought to have reached are not limited to those which they themselves, showing reasonable diligence and having the general knowledge, skill and experience which they respectively had, would have known, ascertained or reached but also those that a person with the general knowledge, skill and experience of someone carrying out their functions would have known, ascertained or reached. The respondents submitted that it became apparent to them in February 1987 that there was no "reasonable prospect" of avoiding insolvent liquidation but their decision to trade on was influenced by the intention to realize the fruit in cold store to protect the interest of their principal and because this was their intention they argued that they had satisfied s.214(3).

This case, in my view, illustrates the dilemma faced by directors when their company is in low financial waters (in *Continental Assurance plc.* the judge described this dilemma[301]). The directors in this case continued trading allegedly to clear the goods as a matter of duty and to protect their principal's interest (even though the same principal was their trade creditor). In my view, directors should have disclosed the true picture to the supplier. It is worth asking, when directors have dual responsibilities whose interests should they look after first. The case signifies the importance of having creditor protective mechanisms in the statute book so that directors are not only aware of their responsibilities but also the interests they have to protect when the company is insolvent or near it.

Judging under the wide scope of s.214, the court found that Murphy and David should have concluded at the end of July 1986 that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Although they did not see the accounts until January 1987, they had an intimate knowledge of the business and must have known that turnover was well down on the previous year that meant a loss, which in

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[301] See para 3.9 below

turn meant an increase in the deficit of assets over liabilities. The court stated that s.214(4) includes a reference not only to facts which a director ought to know but also to those which he ought to ascertain. The court found, in applying the test in s.214(2)(b), that the financial results for the year ending 30 September 1985 were known at the end of July 1986. The respondents did not take “every step” with a view to minimizing the potential loss to creditors of PMC which they ought to have taken as required under s.214(3). Instead, they went on trading for a year after July 1986. The court also did not accept the defence of s.214(3) because it was found that the continued trading by Murphy and David was not restricted to fruit in the cold store only.

In applying the test under which a director is to be judged by the objective standards of what can be expected of a person fulfilling his functions and showing reasonable diligence in doing so (s.214(4)(a)), the court confirmed that the said requirement is to be fulfilled with regard to the particular company and its business. The court, on this standard, noted that the preparation of accounts was woefully late. This was especially the case in relation to accounts dealing with the year ending 30 September 1985 which should have been laid and delivered by the end of July 1986. These are the potential risks to which creditors are exposed which are exacerbated by the fact that shareholders were also directors. This reflects on the need for adequate creditor protection and that is what wrongful trading provisions try to achieve.

Knox J. observed that “the knowledge to be imputed in testing whether or not directors knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation is not limited to the documentary material actually available at the given time.”[302] This appears from s.214(4) which includes a reference to “facts” which a director of a company ought not only to know but those which he ought to ascertain, which does not appear in s.214(2)(b). This indicates that there is to be included by way of factual information not only what was actually there but what, given reasonable diligence and an appropriate level of general knowledge, skill and experience, was ascertainable. Knox J. accordingly assumed for applying the test given in s.214(2),

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[302] *Produce Marketing No.2, supra* note 298 at 595

that respondents knew the financial results for the year ending 30 September 1985 at the end of July 1986 at least to the extent of the size of the deficiency of assets over liabilities. He observed that, although Murphy and David hadn't had the accounts in their hands until January 1987, they knew based on this assumption that the previous trading year had been a very bad one. They had a close and intimate business knowledge and a shrewd idea whether the turnover was up or down. In fact, it was badly down in that year to £526,459. Based on these facts and figures, Knox J. did not accept the directors' plea of not knowing in July 1986[303] that it was down to that precise figure. Judge Knox explained his reasons with the help of an analogy. He said that a major drop in turnover means almost as night following day that a substantial loss has been incurred, which indeed there was in this case. That, in turn, means again, as surely as night following day, a substantial increase in the deficit of assets over liabilities. To Judge Knox, that analogy established Murphy and David's actual knowledge (s.214(4)(b)).

This shows that, in determining what information the directors ought to have known, directors would be assumed to have known the information which would have been revealed had the company complied with its legal obligations to maintain proper books of account and prepare annual accounts.

It is noticeable that the general knowledge, skill and experience postulated in s.214 are much less extensive in a small company with modest business means than in a large company with sophisticated procedures. The court only used minimum accounting standards in *Produce Marketing Ltd. (No.2)* which suggests that the s.214 test is potentially ideal for a small-scale business in the private company context. In Canada, private companies are the norm of business.[304] A wrongful trading kind of provision will boost the protection of creditors of private companies immensely. It will also stress upon Canadian directors to maintain and file proper financial accounts and monitor the financial health of the company vigilantly and regularly.

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[303] The time the liquidator alleged knowing
[304] Nicholls, *Corporate Law, supra* note 124 at 121

The court also considered several other issues relevant to s.214. The court held that it was primarily compensatory as opposed to penal. As to the appropriate amount that a director may be ordered to contribute in the event of liability the court stated that it shall be determined by looking at the amount by which the company's assets became depleted by the director's conduct subject to the court's discretion. The contribution increases the company's assets for the benefit of the general body of creditors.

It is evident that the only way to escape liability under s.214 is set out in s.214(3) i.e., the "every step" test. However, in *Continental Assurance plc.,*[305] a case involving an insurance company which had gone into insolvent liquidation, the liquidator sought relief submitting wrongful trading by directors under s.214 alleging directors continued trading even after holding a crisis meeting. It was held that "the duty of directors generally was not to ensure that the company gets everything right. The duty is to exercise reasonable care and skill up to the standard which the law expects of a director of the sort of company concerned and also up to the standard capable of being achieved by the particular director concerned."[306] This statement, in my view, clarifies that s.214(3) has to be reasonably applied. Otherwise, it would become routine practice to claim wrongfulness in every case of company failure as happened in *Re Continental Assurance plc*.[307]

Unsecured creditors in Canada could be protected better if we had a wrongful trading sort of provision as my analysis shows and academics concur that s.214 is designed particularly to protect unsecured creditors and the payments made thereunder by director(s) form part of the general assets of the company not available to individual creditors. This means that creditors who are creditors before the date when directors are found liable will share with creditors who acquire this status when wrongful trading took place.[308] Knox J. repeatedly mentioned that the bank was substantially secured with a debenture over all the assets of the company and a personal guarantee up to £50,000

[305] *Continental Assurance, supra* note 262
[306] *Continental Assurance, supra* note 262 at 443
[307] *Continental Assurance, supra* note 262 at 437
[308] Ross Grantham, *supra* note 5 at 122

whereas the trade creditors and the supplier of fruits were unsecured. This was one of the factors which the court considered when applying the discretion given under s.214(1).[309] Judge Knox was particularly concerned that any contribution ordered should take account of the benefit already obtained by and the superior position of the powerful creditors so that some benefit is availed by unsecured creditors.[310] It is in this context that I found the Cork Committee's following recommendation amusing: "we believe that these new provisions will prove particularly attractive to bankers concerned at extending facilities to and monitoring the performance of companies of doubtful solvency and to those intending to inject money to such a company or to take up a position on its board."[311] It may be desirable to see if there is any study or research that has explored this aspect that monitoring activities by banks or other financial institutions at the time of extending credit facilities to corporate clients has any such effect as it was dreamed by the Cork Committee.

Regard may also be had to s.214(7) which states that the word "director" includes "shadow director" which is a defined term.[312] While professional advisers are not considered shadow directors under s.251 of the *IA 1986*, they may be so considered if they act in a way that appears to involve instructing rather than advising.[313] The possibility of this issue arose in *Re a Company No. 005009 of 1987*[314] in which a company executed a debenture in favour of the bank three months before going into liquidation and the issue was raised that there was wrongful trading under s.214 for which the bank was liable since it was a shadow director of the company. It was alleged that the directors were accustomed to act in accordance with the bank's directions and instructions.[315] From the analysis of case law, it appears that the court may attach such

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[309] *Produce Marketing No.2, supra* note 298 at 598
[310] Edward Jacobs, "Putting flesh on wrongful trading" (1989) 8:2 Int Bank L 22 at 24
[311] Cork Report, *supra* note 6 at para 1799
[312] Section 251 *IA 1986* defines "Shadow Director" as a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity . . ." This definition corresponds to s.251(1)(2) of *CA 2006* & s.741(1) of *CA 1985*.
[313] Louise Doyle and Andrew Keay, *Insolvency Legislation Annotations and Commentary* (Bristol: Jordans, 2005) at 294 [Keay & Doyle]
[314] *Re a Company No. 005009 of 1987,* [1988] 4 BCC 424 [*Re a Company*]
[315] *Re a Company, supra* note 314 at 426

liability if there is compelling evidence produced by a liquidator generally under s.214(2) (a) and (b). That said, banks would not become shadow directors by merely laying down terms for continuing to provide credit as it is the company's choice whether to take or leave those terms.[316]

I note that this provision extends to de facto[317] as well as de jure[318] directors.[319] In the case of *Re Brian D Pierson (Contractors) Ltd*[320] while discussing liability of a husband and wife who were directors, Hazel Williamson QC said that even though the wife's function in the company's affairs was limited (mainly clerical), she was nonetheless a director who drew a salary and received other fees and benefits as a director. He said that one couldn't be a 'sleeping' director. The test to be applied to her under s.214(4) was that of a reasonably diligent person who has taken on the office of director. Section 214(4)(a) is relevant only where a director performs a special function, such as finance or marketing director, and could not be used to reduce the basic standard on the grounds that the director in question exercised no particular function in the company's management. The judge held that the wife had seen the auditor's report that there was a fundamental uncertainty attaching to the company's accounts but she simply ignored the signs. In having done so, and having failed to appreciate the questions that ought to have been asked about the company's affairs, she was instrumental in its continuing to trade and so liable with her husband for wrongful trading under s.214.[321]

On the issue of whether directors' liability should be joint and several or only several, it is plain from the language of s.214 of the *IA 1986* that the focus is on an individual director and his conduct, not the joint conduct of the board of directors as a whole. The court has discretion to order that two or more directors shall be jointly and severally liable for any

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[316] Keay & Doyle, *supra* note 313 at 295 (citation omitted)

[317] De facto meaning in fact regardless by right or not comparison to de jure meaning appointed legally.

[318] A de facto director claims to act for the company as a director and held out as such by the company even though never appointed properly. Shadow director does not make such a claim, does not held himself out as director. Shadows tend to act behind the scene while de facto directors' activity may be more obvious. Professional advisers are not viewed as shadow directors they might act in such a way as to cross the line by moving from advising to instructing (from Keay & Doyle, *supra* note 313 at 295)

[319] Keay & Doyle, *supra* note 313 at 235

[320] *Re Brian D Pierson (Contractors) Ltd,* [1999] BCC 26 Ch D (sub nom *Penn v Pierson*) [*Re Brian*]

[321] *Re Brian, supra* note 320 at 28

contribution to the company's assets. The initial duty of the court is to determine in the case of each respondent how much he individually should contribute and then to impose joint liability only as a positive exercise of its discretion. [322] The quantum of contribution is also discretionary upon the court. [323] Normally, liability is limited to those consequences which are attributable to wrongfulness.[324]

There are some 113 cases cited under s.214 under a search on Westlaw UK.[325] The claims by liquidators are generally against directors of small private companies. I found only one case of wrongful trading against former directors of a public company but the directors were found not liable.[326] In my analysis, the tests laid down under s.214 are best suited for private (close) corporations. The lack of case law only evidences its effectiveness and forcefulness. To quote Prof. Ziegel: "like a proverbial iceberg, its ramifications are much broader than the reported case law suggests.[327]

3.9 Exculpation of liability

An interesting aspect of the law on directors' liabilities in England is that a court is able to pardon them of liability against a claim for negligence, default, breach of duty or trust under s.1157[328] of the *CA 2006* (which restates without substantive amendment s.727 of

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[322] *Continental Assurance, supra* note 262 at 291 & 440
[323] *Continental Assurance, supra* note 262 at 356-57 & 413
[324] *Continental Assurance, supra* note 262 at 438
[325] My research is not exhaustive (most cases I examined under s.214 are with regard to misfeasance (s. 212) and for preferences and seeking relief under s.727 of *CA 1985)*
[326] *Continental Assurance, supra* note 262
[327] Ziegel, "Creditors Stakeholders", *supra* note 19 at 523
[328] **"Section 1157. Power of court to grant relief in certain cases (Section 727 of *CA 1985*)**
(1) If in proceedings for negligence, default, breach of duty or breach of trust against—
(a) an officer of a company, or
(b) a person employed by a company as auditor (whether he is or is not an officer of the company),
it appears to the court hearing the case that the officer or person is or may be liable but that he acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused, the court may relieve him, either wholly or in part, from his liability on such terms as it thinks fit.
(2) If any such officer or person has reason to apprehend that a claim will or might be made against him in respect of negligence, default, breach of duty or breach of trust—
(a) he may apply to the court for relief, and
(b) the court has the same power to relieve him as it would have had if it had been a court before which proceedings against him for negligence, default, breach of duty or breach of trust had been brought.
(3) Where a case to which subsection (1) applies is being tried by a judge with a jury, the judge, after

the *CA 1985* (originally s.448 of the *CA 1948*)). The court has to be convinced that the director acted honestly and reasonably and it would be fair to excuse him having regard to all the circumstances. The case of *Re Produce Marketing Consortium (In Liquidation) Ltd (No.1)*[329] (*Produce Marketing (No.1)*) illustrates the availability of this provision to directors as a defence to wrongful trading under s.214 of the *IA 1986*. In this case, the respondents (directors) sought relief from liability and the liquidator applied to strike out their claim. The question before the court was whether it had jurisdiction to relieve directors from liability under s.727 of the *CA 1985* for alleged wrongful trading under s.214 of the *IA 1986*. It was held that the jurisdiction of the court under s.727(1) of the *CA 1985* to relieve a director from liability was not exercisable in conjunction with the jurisdiction under s.214 of the *IA 1986* since the question under s.214 whether a director had taken "every step" to minimize creditors' losses was required to be answered objectively according to the knowledge, skill and experience which might reasonably be expected of a person carrying out his functions and according to what he ought to have known before the commencement of the winding up. The question under s.727(1) on the other hand, whether he had acted honestly and reasonably, was to be answered subjectively. Accordingly, the court decided that the directors could not rely on its powers to grant relief under s.727(1) as a defence to proceedings under s.214 of the *IA 1986*.

However, a contrary view was taken in the case of *Re DKG Contractors Ltd*[330] which considered s.214 of the *IA 1986* along with s.727 of the *CA 1985*. In this case company money was paid to a director before liquidation at a time when its solvency was doubtful. The company was incorporated in 1986 but started having financial difficulties in 1988. In February 1988, there were unpaid invoices and some 16 creditors obtained judgments between May and November. It went into creditors voluntary liquidation on December 15, 1998. The liquidator sued directors' on behalf of trade creditors for *inter alia*

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hearing the evidence, may, if he is satisfied that the defendant (in Scotland, the defender) ought in pursuance of that subsection to be relieved either in whole or in part from the liability sought to be enforced against him, withdraw the case from the jury and forthwith direct judgment to be entered for the defendant (in Scotland, grant decree of absolvitor) on such terms as to costs (in Scotland, expenses) or otherwise as the judge may think proper."

[329] *Produce Marketing No.1*, *supra* note 286

[330] *Re DKG Contractors Ltd,* [1990] BCC 903 (Ch D) [*DKG*]

wrongful trading seeking a declaration under s.214 to make a contribution to the company's assets equal to the amount of trade debts incurred by the company on or after May 1, 1988. The respondent directors (Mr. and Mrs. G who were both also the only shareholders) denied the claim. They pleaded to be excused under s.727 for acting honestly and reasonably. John Weeks QC found the respondents liable for wrongful trading under s.214 as they continued trading after April 31, a point in time from which the court found that they should have concluded that there were no reasonable prospect that the company would avoid liquidation. He found that the respondents did not act reasonably to claim exoneration under s.727 as they traded in a manner that gave Mr. G the lion's share of the company money while the outside creditors remained unpaid.

The judge, in its analysis, referred to *Aveling Barford Ltd v Perion Ltd*[331] wherein Hoffmann J referred to the general rule that any act which falls within the powers of a company whether or not a breach of duty on the part of the directors is binding on the company if it is approved by all its shareholders. This rule, however, has two important exceptions. One, creditors are entitled to have the company's assets kept intact. Two, it does not extend to cases involving fraud on creditors. John Weeks QC found that the case of *DKG Contractors Ltd*[332] falls within both exceptions as the company's assets were not preserved for general creditors and the method of operating was also unfair to general creditors of company (considering doubtful solvency). The court accepted that they were not dishonest but simply incompetent (or "hopelessly inadequate"). Judge Weeks indicated that in the new climate every director should acquaint himself with the minimum standard of performance required by law i.e., the keeping of proper books of account, or face the consequences when the company collapses.[333] This happened in *Peoples* in which directors were arguably simply incompetent.[334] This supports my claim that Canada should have a wrongful trading kind of provision. Cases like *Peoples* and *DKG Contractors Ltd*[335] are illustrations of the uncompensated perils creditors face.

[331] *Aveling Barford Ltd v Perion Ltd,* [1989] 5 BCC 677 at 682A
[332] *DKG, supra* note 330
[333] David Milman & Chris Durrant, *Corporate Insolvency: Law and Practice*, 3rd ed. (London: Sweet & Maxwell, 1999) at 233 [Milman]
[334] See chapter 5
[335] *DKG, supra* note 330

These are unjust risks borne by creditors and that is why they require more protection. It may be argued as to why should the law only be concerned about protecting creditors from incompetent directors? Why are shareholders not also entitled to such protection? I would say corporate law has provided shareholders specific mechanisms (derivative action, oppression action, fiduciary duties, duty of care and the right to elect and remove directors) that works absolutely fine for them whereas creditors have no specifically designed legal mechanisms against directors if their interests are threatened in or near insolvency when their interests are vulnerable. Oppression remedy is available to creditors but it was designed specifically to protect minority shareholders and not creditors. It has helped creditors in a few cases but overall has not been a successful remedy for creditors. It suffers serious limitations in protecting creditors interests that I have discussed in para 2.6 above and also in chapter 5. A wrongful trading provision would thus provide creditors more defined protection.

In both *Re DKG Contractors Ltd*[336] (above) and *Re D' Jan of London Ltd*[337](below) the court applied the standard of care under s.214 to grant relief to directors under s.727. In light of these decisions it may be disputable to say that s.727 and s.214 are not compatible as was held by the earlier decision in *Produce Marketing (No.1).*[338] That said, how far this issue is mooted is uncertain considering s.727 requires examination that the director has acted honestly whereas such mental element arguably is not a part of the enquiry under s.214. Honesty and sincerity are not the same as prudence and reasonableness.[339] Another argument is that in the case of *Re D' Jan of London Ltd* the company was not insolvent. I also argue that applying s.1157 to s.214 negates the “every step” defence purposefully laid down under s.214(3). The legislature could not have intended otherwise in the presence of s.214(3). This is probably a grey area and future case law may be able to explain it better.

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[336] *DKG, supra* note 330
[337] *D'Jan, supra* note 238
[338] *Produce Marketing No.1, supra* note 286
[339] *Cowan v Scargill,* [1984] 2 All ER 750 at 762

In *Re D' Jan of London Ltd*,[340] s.727 was applied to s.214. It was an action brought by the liquidator against D director of a company alleging breach of the duty of care at common law. D had signed an insurance proposal, completed by another person, which he had not read. The insurers repudiated liability under the policy on the grounds that the proposal as completed contained inaccurate information. It was held in that case that the duty of care that a director owed to a company at the common law was equivalent to that in s.214(4) of the *IA 1986*.[341] Both on the objective test and subjective test, D was found not diligent for signing the form without reading it. Hoffman LJ interestingly regarded this as an appropriate case for the court to exercise its discretion under s.727 of the *CA 1985* in that the negligence of D was not gross, the company was solvent at the time of completion of the proposal and the only persons whose interests were foreseeably being put at risk were those of D and his wife. The judge found that D acted honestly and reasonably. In Hoffman LJ's words: "it may be reasonable to take a risk in relation to your own money which would be unreasonable in relation to someone else's". In his judgment it was fair for the purposes of s.727, to excuse D for some though not all of the liability, which he would otherwise have incurred. The Judge accordingly did not ask D to return what he had actually received or make a contribution out of his own pocket to the company's assets. The court only ordered D to compensate the company in principle for breaching his duty to the amount of any sum that was due to him by way of dividend in the liquidation of the company. In exercising jurisdiction under s.727 of the *CA 1985*, the judge applied s.214(4) of the *IA 1986.*

In my view, in this case the Judge was sympathetic in exercising discretion under s.727 as the only two shareholders of the company were D (holding 99 shares out of 100 issued) and his wife and their argument was that the company could not complain of the breach of duty because of the principle of company law that an act authorized by all the shareholders is legally an act of the company. It may also have helped that they were not grossly negligent in failing to read the form. It was the kind of thing which could happen to any busy person. But the most distinguishable aspect of this case is that the company

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[340] *D'Jan, supra* note 238

[341] *D'Jan, supra* note 238 at 648

was solvent and the only persons whose interests D foreseeably put at risk by not reading the form were his own and his wife's. The findings of this case may be compared with *Re DKG Contractors Ltd*[342] in which the court found the respondent directors' conduct of paying money to Mr. G unreasonable because at that time the company was in doubtful solvency which was not the case here.

Rizwaan Mokal appears to be correct when he states that s.214 is most relevant to companies whose directors themselves own a substantial chunk of the firm's equity.[343] It is correct because directors of such companies have a margin to engage in self-dealing or other kind of misconduct without being challenged or noticed whereas in large public corporations it would be problematic to engage in such conduct because of the board's independent structure and proper accounting and monitoring standards plus regulatory checks and balances. Needless to say, this kind of behaviour would be costly to creditors of any company that is insolvent or near it. Hence, there is a need for more protection.

The purpose of this extensive discussion is to highlight the importance of creditor protection. As pointed out, creditors of small companies are more at risk due to the absence of checks and common shareholding structure. The situation is the same in Canada making it all so important to consider more creditor protection and wrongful trading provisions could potentially achieve that.

3.10 Does s.214 deliver?

Yes, s.214 does do the job. That said, it is only fair that I also mention some of the concerns that have been raised that may potentially limit its effectiveness. That is not to say that the provision is not an effective tool to protect creditors. The provision has sufficiently protected creditors in England and that is the reason that other common law

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[342] *DKG, supra* note 330

[343] Rizwaan Jameel Mokal, *Corporate Insolvency Law Theory and Application* (Oxford University Press, 2005) at 266

jurisdictions including New Zealand[344] and Australia[345] followed England's footsteps in adopting a similar provision in their corporate statutes. It could potentially be useful to Canada as well that has no corresponding protection for creditors in its corporate statutes despite sharing similar duties of directors at the common law. The judicial opinion is that the duty as stated in s.214(4) of the *IA 1986* accurately states the duty of care owned by directors at the common law.[346] That speaks volumes for its relevancy and authenticity and is definitely worth considering. The concerns that I shall discuss below are all general and procedural and do not relate to the underlying substance or rationale of this provision which is to provide creditors protection.

One criticism is with regard to identifying a point in time from which a company is alleged to be involved in wrongful trading (s.214(2)(b)), the date from which the director should have realized that insolvent liquidation was inevitable. This is a challenging task. A liquidator has to accurately pin point these dates because once evidence is heard he may not invite the court to pick a different date. This rigid approach has been adopted in *Re Sherborne Associates Ltd*[347] and *Continental Assurance plc.*[348] On the other hand, I also found cases where courts have taken a flexible approach. For example, in *Re DKG Contractors Ltd*[349] the court found the respondents liable in relation to wrongful trading from April 31, 1988 even though the argued date by the liquidator was the end of July 1988.[350] In *Official Receiver v Doshi*[351] it was held that the respondent was engaged in wrongful trading from November 1992, not February 1992.[352] I found uncertainty in the case law surrounding "the point in time" that constitutes "reasonable prospect". Keay may be right that this concept is "inherently elusive"."[353] But given the divergent

[344] *Companies Act* 1993 (No.105), ss. 135 and 136 (New Zealand) (see Ross Grantham, *supra* note 5 at 127)
[345] Section 588 G of the *Corporations Act* 2001 (Australian) (see Duggan, *supra* note 157 at 491)
[346] *D'Jan, supra* note 238 at 648
[347] *Re Sherborne Associates Ltd*, [1995] BCC 40 at 42
[348] *Continental Assurance, supra* note 262 at 297 & 328
[349] *DKG, supra* note 330
[350] *DKG, supra* note 330 at 912
[351] *Official Receiver v Doshi*, [2001] 2 BCLC 235 (Ch D) [*Doshi*]
[352] *Doshi, supra* note 351 at 281
[353] Keay,"skinning a cat", *supra* note 275 at 2

approaches by the judges on this issue[354] a decisive court view on this issue is desirable.[355] It also raises a policy concern as to how far back it may be appropriate for any judge to examine the trading of a company against the alleged wrongdoing. Thus, future case law may provide guidance.

The judgment awarded in *Continental Assurance plc*.,[356] may concern liquidators on the question of liability and determination of loss. In this case, joint liquidators brought proceedings against the eight directors of Continental Assurance Co of London plc. claiming that they were liable to contribute the sum of £3,569,000 for the increase in net deficiency alleged to have been caused by wrongful trading and misfeasance on the part of the directors. The court dismissed their claim as it was found to be based on hindsight and wholly ignored the realities of the position of company directors facing the situation. In its analysis the court took note of the fact that in financial distress the directors face a real and unenviable dilemma of deciding whether to close down and go into liquidation, or whether instead to trade on and hope to turn the company around. If they decide to trade on but things do not work out and the company, later rather than sooner, went into liquidation, they could find themselves being sued for wrongful trading. On the other hand, if they decide to close down immediately and cause the company to go into an early liquidation they are at risk of being criticized for shutting down too soon when they ought to have had the courage to keep going. This is because, if the company survives, all of its debts would be paid and an expensive liquidation, in which the creditors are unlikely to be paid in full, would be avoided. I would describe this concern of liquidators as unfounded. Section 214(3) requires fulfillment of every step taken to reduce further loss to creditors "based on the reasonable knowledge" of directors that the company would not be able to avoid going into insolvent liquidation. If this test is satisfied, the court does not make a declaration. The provision itself is silent on the question of causation but there has to be a connection between breach of duties to the requisite

[354] Notably *Re Sherborne Assoicates Ltd* & *Re Continental Assurance Company of London plc*
[355] Andrew Keay, "Wrongful trading and the point of liability"(2006) 19:9 Insolv Int 132 at 134
[356] *Continental Assurance, supra* note 262

standard under this provision and the loss in question.[357] As explained below, the court had valid grounds for not making a declaration against directors.

The court in *Continental Assurance plc.,*[358] was prepared to impose liability on directors on the ground that there had been an unjustified decision to carry on trading but felt it was not enough. To justify liability, there has to be more than a mere 'but for' nexus of that type to connect the wrongfulness of the directors' conduct with the company's losses which the liquidator should claim to recover from them.[359] The judge observed that that “nexus” would be obvious where a director turns a blind eye to inherent loss making.[360] The court noted that not every loss which a company sustains after the directors have reached a wrongful decision to trade on may be recoverable. The starting point for liability under s.214 is any element of loss to the company from its trading on instead of going into liquidation at the earlier date. The continued trading, albeit wrongful, has to make the company's position worse so that it has less money available to pay creditors rather than to leave the company's position at the same level. It must make the company's position worse before it becomes appropriate for the court to order the directors to make a contribution.[361] A reason for court’s sympathy towards directors could be due to the presence of non-executive directors on the board and there may be a concern not to send a wrong signal (Park J. was very aware of the dangers of judging the directors’ conduct on the basis of hindsight and was concerned that directors may decline such posts in future for fear of liability) to other non-executive directors. That said, the directors’ reliance on professional advice must have been a huge mitigating factor for a decision in their favour.

The ‘but for’ nexus connection to wrongfulness of directors’ conduct with respect to the company’s losses could have been arguably easily established in *Peoples* where directors virtually turned a blind eye to the financial state despite knowing that the business was

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[357] Sealy & Milman, *Annotated Guide to the Insolvency Legislation*, vol 1, 12th ed. (Sweet & Maxwell, 2009) at 205 (citation omitted)
[358] *Continental Assurance, supra* note 262
[359] *Continental Assurance, supra* note 262 at 289
[360] *Continental Assurance, supra* note 262 at 437
[361] *Continental Assurance, supra* note 262 at 296

inherently loss making. The principle laid down in *Continental Assurance plc.* fits the action of the *Peoples* directors but in Canada wrongful trading by directors is not prohibited.[362] The effect of wrongful trading provisions is deterrence and responsible risk taking for all the companies whether start up or established. The doctrine is confined to culpable negligent disregard of the interests of creditors after the time when the director concerned knew or ought to have known that there was no reasonable prospect of the company to avoid insolvent liquidation.[363] Honesty, fraud or dishonesty is not requisite to attract the provision, which is based on the state of knowledge of directors at the relevant date.[364] It may therefore be possible that directors who are honest but incompetent lose the benefit of limited liability. That said the provision does not specify the precise action directors are required to take to meet its requirements. It lays down a standard not a rule, to which a director must adhere to in order to avoid liability i.e., "to take every step with a view to minimizing the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken."[365] Whether in this situation the provision requires the directors in all cases to cease immediate trading is a question of fact and may depend upon how broadly the court would view the directors action in a particular case. According to one commentator the courts could adjust the provision to the needs of "rescue culture" by postponing the point at which they say that the directors ought to have concluded the company had no reasonable prospect of avoiding insolvent liquidation as was done in the *Continental Assurance plc.*[366] That said, it has been recognized in the literature that one of the most common forms of wrongful trading is to keep the company's business going even after the accounts or other information have expressly shown that the company is in a chronically loss making position as was the case in *Produce Marketing Ltd. (No.2)*[367]. However, it is not considered wrongful trading to bring a company to the brink of insolvency by negligent mismanagement.[368] It is the failure thereafter, when the writing is on the wall, to take proper steps for the protection

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[362] See further analysis in chapter 5
[363] Goode, *supra* note 1 at 665
[364] *Re Hawkes, supra* note 95 at 949
[365] Gower, *supra* note 189 at 222
[366] Gower, *supra* note 189 at 222-223
[367] Gower, *supra* note 189 at 222
[368] Goode, *supra* note 1 at 667

of creditors that attracts wrongful trading provision.[369] The pre-mature cessation of trading might be considered wrongful trading.[370] If there is a real possibility that the company could trade out of its difficulties or that an outside investor is prepared to invest in the company, there is no liability under this doctrine even if the directors knew the company to be insolvent.[371] The provision is not at all aimed at discouraging prospective directors to begin business for the first time but aimed at responsible risk taking. In *Re Hawkes Hill Publishing Co Ltd (in Liq)*[372] (*Re Hawkes*) the judge in the context of a start up publishing company that became insolvent with a deficiency for unsecured creditors of over £117,000 clearly stated: "it would be stultifying to legitimate business enterprise if the law were to require company directors to put their companies into insolvent liquidation at the first sign of trouble."[373] It further held that "it is easy with hindsight to conclude that mistakes were made. An insolvent liquidation will almost always result in from one or more mistakes. But picking over the bones of a dead company in a courtroom is not always fair to those who struggled to keep going in the reasonable (but ultimately misplaced) hope that things would get better."[374] The crucial enquiry under the wrongful trading provision is: did the director know or ought to have concluded that there was no reasonable prospect that the company would avoid an insolvent liquidation? It is a fact intensive enquiry but according to case law "the answer to this question does not depend on a snap shot of the company's financial position at any given time; it depends on rational expectations of what the future might hold. But directors are not clairvoyant and the fact that they fail to see what eventually comes to pass does not mean that they are guilty of wrongful trading."[375]

It is obvious that "insolvency" triggers the duty. However, most cases contemplate that the duty will also be triggered in certain circumstances short of insolvency.[376] Identifying

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[369] Goode, *supra* note 1 at 667
[370] Goode, *supra* note 1 at 667
[371] Goode, *supra* note 1 at 670 (citing *Re Hawkes, supra* note 95)
[372] *Re Hawkes, supra* note 95
[373] *Re Hawkes, supra* note 95 at 951-952
[374] *Re Hawkes, supra* note 95 at 952
[375] *Re Hawkes, supra* note 95 at 950
[376] *Gwyer, supra* note 9 at 178 (the duty was expressed as arising where the company was "insolvent or of doubtful solvency or on the verge of insolvency); *Brady*, *supra* note 194 (the interests of the company were in reality the interests of existing creditors alone where the company was insolvent, or even doubtfully

those circumstances is a tough task and the case law has not yet explained that. Even the concept of insolvency itself as a trigger for the duty is problematic because "insolvency" may mean different things. There are however two main financial tests for insolvency[377] i.e., the cash flow test and the balance sheet (or assets) test.[378] Under the cash flow test a company is unable to pay its debts as they fall due.[379] Under the balance sheet test, a company is insolvent if the value of its net assets[380] is insufficient to cover its liabilities and the expenses of winding up at the relevant date.[381] Authorities on these tests are sparse. However, s.214(6) of the *IA 1986* only requires the balance sheet test. This is a deviation from the Cork Committee's recommendations which suggested that its proposals be applied not only to a company which is unable to pay its debts as they fall due but also to a company which is insolvent, i.e. liabilities exceed its assets as well as when a company is heavily under capitalized. It was so recommended because, in their view, the essence of wrongful trading is the incurring of debts with no reasonable prospect of meeting them; whether by incurring debts with no reasonable prospect of paying them, or by taking payment in advance for goods to be supplied with no reasonable prospect of being able to supply them or return the money in default.[382] It is relatively easy to know whether the cash flow test is met - the company simply fails to keep up payments of its debts. The balance sheet test is more difficult for, although most companies going into liquidation have an obvious deficiency of assets, there may be marginal cases where everything depends on the valuation of assets and liabilities. Assets

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solvent.); *GHLM, supra* note 272 at 165 (interests of creditors could intrude even when a company may not strictly be insolvent)

[377] Roy M. Goode, "Wrongful trading and the balance sheet test of insolvency" (1989) J B L. Sept, 436-439 at 436 [Goode]

[378] Both these tests are mentioned in *IA 1986*. Section 123(1)(e) provides for cash flow test and s.123(2) for balance sheet test with regard to the grounds on which a company is to be deemed insolvent for the purpose of jurisdiction to make a winding up order. Section 214 (6) also provides for balance sheet test with regard to wrongful trading only.

[379] *Re Capital Annuities Ltd,* [1979] 1 WLR 170 (within the meaning of s.223(d) of the *CA 1948*); *Tweeds Garages Ltd,* [1962] Ch 406 at 413 (stating that if a company has a large number of outstanding debts and unsatisfied judgments it would mean cash flow insolvency in the context of winding up)

[380] Goode, *supra* note 1 at 134

[381] Section 214 of the *IA 1986* and s.6 of the *CDDA 1986* provides for it; *Byblos Bank SAL v Al-Khudhairy,* [1986] 2 BCC 99 at 247 (Nicholls LJ giving example that a company whose liabilities consist of an obligation to repay a loan of £100,000 and whose only assets are worth £10,000 taking into account its future liabilities, such a company does not have the present capacity to pay its debts and as such it 'is' unable to pay its debts. Even if all its assets were realized it would still be unable to pay its debts, viz., in this example, to meet its liabilities when they became due)

[382] Cork Report *supra* note 6 at para 1784 & 1785

may rise or fall in value because of events occurring after the relevant date. It may be due to these complications that the case law indicates that it has been left on the party asserting a state of insolvency to prove that as it was done in *Continental Assurance plc*.[383] It is, thus, for the plaintiff or applicant to show that on the balance of probabilities the company was insolvent at the relevant time. However, as proof of insolvency is not the threshold for institution of wrongful trading proceedings, it would be relatively easy for a liquidator to file for the same. During the course of liquidation, he would develop a reasonable knowledge of the relevant facts and the actual amounts realized on the disposal of assets would provide him additional guidance of their value at the relevant time to pursue this action.[384] The court also has no problem applying hindsight in this situation, for it only has to consider whether there is a net deficiency of assets and if so how the liability should be imposed on directors to contribute to the assets.[385] But the courts are not influenced or biased by hindsight, as the enquiry under this provision is factual and objective. English courts have been cautious of the unfairness that hindsight may cause to directors. In *Re Hawkes* the court quoted from *Re C S Holidays Ltd; Secretary of State for Trade and Industry v Gash*[386] as follows:

> "The companies legislation does not impose on directors a statutory duty to ensure that their company does not trade while insolvent; nor does that legislation impose an obligation to ensure that the company does not trade at a loss. Those propositions need only to be stated to be recognized as self-evident. Directors may properly take the view that it is in the interests of the company and of its creditors that, although insolvent, the company should continue to trade out of its difficulties. They may properly take the view that it is in the interests of the company and its creditors that some lossmaking trade should be accepted in anticipation of future profitability. They are not to be criticized if they give effect to such view."[387]

[383] *Continental Assurance, supra* note 262
[384] Goode, *supra* note 1 at 4-33
[385] Goode, *supra* note 1 at 14-30
[386] [1997] BCC 172 at 178; [1997] 1 WLR 407 at 414
[387] *Re Hawkes, supra* note 95 at 947

Thus, the comments on the difficulty of tests of insolvency are more in the context of cases where proof of insolvency is the threshold test to file for proceedings such as creditors winding up on the ground of insolvency[388] and not necessarily in wrongful trading case as explained above.

In *Peoples*, the directors failed to administer the accounts of the companies with responsibility. I have argued in my analysis in chapter 5 that the companies were in a state of insolvency from the very inception of their purchasing Peoples Inc. Peoples Inc. was a faltering chain of M&S which prior to acquisition by Wise Inc., was loss making to the extent of $10 million per year. The purchaser Wise Inc. was under capitalized and facing liquidity crunch. Sales figures of the two corporations were constantly on the decline. I am not saying that immediately following the purchase the directors should have gone out of business. I am not implying that no company that is losing money should ever by purchased or that the Wise brothers made a bad decision in buying Peoples Inc. in the first place. The wrongful trading provisions kick in when there is no reasonable prospect of a company avoiding insolvent liquidation and not before that. The onus of showing this "deemed knowledge" of insolvency is on the director concerned along with the proof that he took the proper steps to minimize the potential loss to creditors. The provision is "confined to culpable conduct after the time the director concerned knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation."[389] The court applies an objective and subjective standard to the facts of the case and the net deficiency of the assets helps it in determining insolvency at the relevant date. It is arguable that the court second-guesses directors because of the fact intensive enquiry which in my view eliminates allegations of any hindsight influences or biases. Applying the said test, it would have been apparent that my argument has ground regarding directors' conduct in *Peoples*. But there is no legal ground in Canada to apply for wrongful trading after the time when the director concerned knew or ought to have concluded that there was no reasonable prospect of the

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[388] Goode, *supra* note 1 at 4-33
[389] Goode, *supra* note 1 at 665

in *Continental Assurance plc.*[394] In his view, when wrongful trading was first introduced in the Act, there was great optimism but that feeling has diminished as problems have surfaced and the actions that are brought thereunder often fail.[395] Schulte opines that s.214 "is of no interest to a liquidator, no benefit to creditors, and for wrongdoers it is the impotent progeny of a fine legal theory."[396] That said, it might be kept in mind that those criticisms are not founded on empirical evidence. On the contrary, according to the findings of one survey, s.214 has encouraged directors to be responsible in making decisions in light of insolvency.[397]

To sum up, in this Part, I tracked the development of the common law duty to consider creditors' interests in a company that is insolvent or on the verge of insolvency. I found that the common law imposes an obligation on directors to consider creditors' interests in an insolvent or on the verge of insolvent company when carrying out their duty to the company. That said, the duty is generally considered indirect even though there is case law which states otherwise. There are no tests or rules to determine the "verge of insolvency" or "zone of insolvency" period which is an important limitation to directors' duty to creditors at common law. England has incorporated special remedial measures for creditors in the *IA 1986*. The most important provisions under that statute are the ones setting out wrongful and fraudulent trading. Directors who are found liable for such activities could be disqualified. In *Re D' Jan of London Ltd.*, Hoffman LJ said that the duty as stated in s.214 of the *IA 1986* states accurately the duty of care of directors at common law.[398] That says a lot about the relevancy of this provision in the statute book creating a positive duty on directors to consider creditors' interests in or near insolvency. Section 214 lays down a test to determine insolvent liquidation but arguably by the time a company is insolvent it has already passed this "zone of insolvency" for which presently there are no tests and this affects creditors directly. It is, thus, a kind of penumbral area facing all jurisdictions under my study. Wrongful trading is linked with disqualification

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394 *Continental Assurance, supra* note 262
395 Keay, "skinning a cat"*, supra* note 275 at 2
396 Richard Schulte, "Enforcing wrongful trading as a standard of conduct for directors and a remedy for creditors: the special case of corporate insolvency" (1999) 20:3 Comp Law 80 at 88.
397 Keay, *Responsibilities to Creditors, supra* note 85 at 140
398 D'Jan, *supra* note 238 at 648

of directors under the *CDDA 1986*. But the scope of *CDDA 1986* extends beyond just wrongful trading. It plays a major public role that benefits creditors as well in addition to the wrongful trading provisions. This is discussed next.

3.11 Disqualification of directors

The Cork Committee[399] in recommending this reform was of the view that "proper safeguards for the general public" require that wrongful trading be supplemented by the law "that those whose conduct has shown them to be unfitted to manage the affairs of a company with limited liability shall, for a specified period, be prohibited from doing so".[400] The Committee's proposal was influenced by the widespread public dissatisfaction at the ease with which, in the Committee's own words, "a person trading through the medium of one of more companies with limited liability can allow such a company to become insolvent, form a new company, and then carry on trading much as before, leaving behind him a trail of unpaid creditors, and often repeating the process several times.[401] The Committee felt this dissatisfaction greatest "where the director of an insolvent company has set up business again, using a similar name for the new company, and trades with assets purchased at a discount from the liquidator of the old company."[402] In formulating its proposals on this legislation the Committee recognized the need not to deter legitimate enterprise and sought to protect the non-executive directors in large enterprises, yet "severely penalizing those who abuse the privilege of limited liability by operating behind the one-man, insufficiently capitalized companies on the other."[403]

The Committee's recommendations received statutory acceptance, though not exactly in the form suggested, in the insolvency law reforms of the mid-1980s and soon the disqualification provisions were consolidated into the *CDDA 1986*.[404] The *CDDA 1986* primarily serves to protect creditors in the context of disqualification orders for wrongful

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[399] Cork Report, *supra* note 6
[400] Cork Report, *supra* note 6 at para 1808
[401] Cork Report, *supra* note 6 at para 1813
[402] Cork Report, *supra* note 6 at para 1813
[403] Cork Report, *supra* note 6 at para 1815
[404] Gower, *supra* note 189 at 238

trading, fraudulent trading and unfitness. If wrongful trading is found, the court may disqualify the incompetent director. It has occurred in a number of instances with *Re Brian D Pierson (Contractors) Ltd*[405] being one example. However, if fraudulent conduct is found, the director could be tried under s.213 of the *IA 1986*. It also makes provision for personal liability where a person acts in breach of a disqualification order. It demonstrates that misuse of limited liability is the basis of these disqualification orders.[406] The Act directly enhances creditor protection by removing from the system directors whose conduct falls short of the appropriate standards and by discouraging such conduct in serving directors by inducing fear of disqualification. In this sense, it has a huge deterrent effect. A related but subsidiary aim is to enhance honesty and diligence in corporate management.[407]

Under the *CDDA 1986,* the courts have wide statutory powers to ban directors of companies that have gone into insolvent liquidation or people who have committed serious or persistent breaches of the company law. The court may make an order against a person who has:

(i) been convicted of an indictable offence in connection with the formation or management of a company (s.2);

(ii) been persistently in breach of his or her obligations under the Companies Act e.g., to file returns (ss.3 & 5);

(iii) been guilty of fraud or fraudulent trading revealed in a winding up (s.4);

(iv) been a director of a company that has become insolvent and who is found "unfit" to be concerned in the management of a company (s.6), or similarly been found "unfit" after a statutory investigation into the affairs of a company (s.8);

(v) been guilty of fraudulent or wrongful trading as defined in ss.213-214 of *IA 1986* (s.10);

(vi) been a director of a company that has breached competition law and who is

[405] Brian, *supra* note 320
[406] Gower, *supra* note 189 at 241
[407] Sealy, *supra* note 69 at 286

> found “unfit” to be concerned in the management of a company (s.9A).[408]

Sections 6 and 8 of the *CDDA 1986* are the most important because of the statutory concept of “unfitness” which is elaborated upon in Schedule 1. These provisions amplify the directors’ common law duties of care and skill. It is, however, considered a “growth area” setting out standards of conduct to foster greater awareness of the responsibilities of directors.[409] The following quotation from the judgment of Jonathan Parker J. in *Re Barings Plc. (No.5)*[410] (*Re Barings*) usefully explains the relevance of Schedule 1 of the *CDDA 1986* regarding the concept of “unfitness”:

> “Although in considering the question of unfitness the court had to have regard (among other things) to ‘any misfeasance or breach of any fiduciary or other duty’ by the respondent in relation to the company, it is not in my judgment a prerequisite of a finding of unfitness that the respondent should have been guilty of misfeasance or breach of duty in relation to the company. Unfitness may in my judgment be demonstrated by conduct which does not involve a breach of any statutory or common law duty: for example, trading at the risk of creditors might be the basis of a finding of unfitness even though it might not amount to wrongful trading under s.214 of the Insolvency Act 1986. Nor, in my judgment will it necessarily be an answer to a charge of unfitness founded on allegations of incompetence that the errors, which the respondent made, can be characterized as errors of judgment rather than as negligent mistakes. It is I think possible to envisage a case where a respondent has shown himself so completely lacking in judgment as to justify a finding of unfitness, notwithstanding that he has not been guilty of misfeasance or breach of duty. Conversely in my judgment the fact that a respondent may have been guilty of misfeasance or breach of duty did not necessarily mean that he is unfit. As Schedule 1 makes clear, there are a number of matters to which the court is required to have regard in considering the question of unfitness, in addition to misfeasance and breach of duty.”[411]

“Unfitness” is a very broad concept and a farsighted approach to good corporate governance. It is an additional criterion upon which directors’ conduct may be scrutinized by the court. Insolvency is the trigger point for evaluation of a person’s whole conduct as a director to determine his unfitness for that office. This evaluation is not limited to the

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408 Sealy, *supra* note 69 at 286 (citations omitted)
409 Sealy, *supra* note 69 at 286
410 *Re Barings Plc. (No.5) v Baker*, [1999] 1 BCLC 433 (Ch D) [*Barings*]
411 *Barings, supra* note 410 at 486

period immediately preceding insolvency as in the case of wrongful trading. Courts have generally divided unfitness cases into two categories: probity and competence.[412] In assessing unfitness, the courts give regard to the extent the director was responsible for the insolvency of the company.[413] The courts use a "marked degree" of negligence standard for declaring a director unfit.[414] It is to be noted that this is a different standard from wrongful trading and the duty of care, which is chiefly due to the severe consequences that a disqualification order brings to the person (e.g., losing job and minimum two years of disqualification).[415] Under several of the provisions of the *CDDA 1986* the court is empowered to grant disqualification order of its own motion but disqualification on the ground of unfitness to act as director is made on the application by the Secretary of State or in the case of a company in compulsory winding up, the official receiver if so directed by the Secretary of State.[416]

The *CDDA 1986* requires the court to disqualify a director for a minimum 2-year period (maximum 15-year) whether or not necessary in the public interest if it makes a finding of "unfitness"[417]. The length of the period of the disqualification is within the discretion of the judge.[418] It is a question of fact whether a director is unfit but past decisions of the court may be helpful in identifying particular circumstances in which a director would clearly be unfit.[419]

The *CDDA 1986* was amended in 2000 to allow the Secretary of State to accept disqualification undertakings from directors themselves that they would for specified periods refrain doing activities such as those prohibited by a disqualification order. It is achieved by an out of court agreement between the Secretary of State and the director

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412 Gower, *supra* note 189 at 246
413 Gower, *supra* note 189 at 246-247
414 Gower, *supra* note 189 at 249
415 Gower, *supra* note 189 at 249
416 Goode, *supra* note 1 at 692
417 *Re Grayan Building Services Ltd., (in Liquidation),* [1995] Ch 241 (CA) ([*Grayan*]
418 *Grayan, supra* note 417 at 167
419 *Re Sevenoaks Stationers (Retail) Ltd,* [1991] Ch 164 at 176 (CA) [*Sevenoaks*](as regards the period of disqualification the Court divided potential 15 years disqualification period into 3 brackets depending on the seriousness of the complaint (at174) i.e., (i) over 10 years for the most serious cases (ii) 6 to 10 years for less serious cases than the top bracket and (iii) 2 to 5 years where the case is not very serious)

concerned without court hearing.[420] If a director disagrees with the terms of the undertaking he could approach the court but shall normally be responsible for his own costs as well as the Secretary of State's.[421] Apparently, these undertakings have identical consequences to disqualification orders. Thus, the reforms of 2000 basically introduced out of court "disqualification undertakings" to supplement the "disqualification order" which only a court could make.[422] It has been reported that, in the past few years, about 80% of all disqualifications have resulted from such undertakings as opposed to any court orders.[423] It is stated that, as a result of this Act, about 1,500 disqualifications are happening in the UK per year.[424] It may be argued that the high number of disqualifications suggests that problems with directors' conduct are widespread and have not been helped by the law. I would say that it might be true that the problems with directors' conduct are widespread but it would be wrong to say that the law is not helpful. After all if the *CDDA 1986* had not been promulgated how could these disqualifications occurred in the first place? The *CDDA 1986* has provided a remedy against directors' whose conduct falls below standard in the form of sanctions. The high number of the out of court disqualification undertakings therefore in my view suggests that this legal mechanism has been useful in raising standards and deterrence in directors. In fact an independent survey in England has also found widespread agreement that the provisions perform a useful role.[425]

To sum up the discussion on the *CDDA 1986*, the courts' wide discretionary powers under this Act to ban directors of companies found liable for fraudulent trading (discussed next) and wrongful trading protects primarily the interests of creditors as those found guilty of such acts would be disqualified to manage the business and affairs of the company for a specified time. The disqualification and stigma of reputation creates a corporate culture where directors' fear falling below the requisite standards of conduct under the *CDDA 1986*. According to Goode "any misconduct as director whether or not

[420] Gower, *supra* note 189 at 239
[421] Gower, *supra* note 189 at 239
[422] Gower, *supra* note 189 at 238
[423] Sealy, *supra* note 69 at 287
[424] Sealy, *supra* note 69 at 286
[425] Gower, *supra* note 189 at 255 (citing Andrew Hicks, Disqualification of Directors: No Hiding Place for the Unfit? (ACCA Research Report 59, 1998)

mentioned in the Schedule or whether or not a breach of a specific provision of the Companies Act or the Insolvency Act, may be relevant and in deciding on disqualification the court may examine the matters of conduct established and consider them both separately ad cumulatively."[426] Needless to say, if competent people will be occupying the board of directors' seats then chances are they will act diligently and prudently when any financial crisis hits the company. The Act works as a shield for creditors as it removes from the system corporate managers who could be threat to their interests. It is an important piece of legislation and may be considered in Canada along with the wrongful trading provisions. There is no provision in the *CBCA* or *OBCA* for disqualification orders or undertakings of the type mentioned above. There is also no wrongful trading sort of provision in Canada. Both these mechanisms complement each other and work side by side and are worth considering in Canada in order to give more protection to creditors from directors who abuse limited liability. The disqualification of incompetent directors could be fruitful in the enforcement of directors' standards of competence which would reduce actions for breach of duty of care and, thus, save costs to litigants. England is much ahead of Canada in recognizing the need for adopting protective measures for creditors. Canada needs these mechanisms for more protection of creditors. In the next Part, my discussion is about fraudulent trading that prohibits conducting the business of a corporation with intent to defraud creditors (or indeed for any fraudulent purpose). It applies in any winding up regardless of whether the company is insolvent or not.[427] The fraudulent trading provision is also connected with the *CDDA 1986*.

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[426] Goode, *supra* note 1 at 696 (citations omitted)
[427] Peter Loose, *supra* note 257 at ch. 2, para 7.74

III. FRAUDULENT TRADING

3.12 Introduction

Section 213[428] of the *IA 1986* comprises the civil remedy for fraudulent trading in these terms: (1) If in the course of the winding up of a company it appears that any business of a company has been carried on with intent to defraud creditors of the company . . . or for any fraudulent purpose . . . (2) the court on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

There is also a statutory provision at s.993[429] of the *CA 2006* (s.458[430] of the *CA 1985*), for the criminal conviction on prosecution of a person knowingly party to the carrying on of the business of a company with such intent to defraud or such fraudulent purpose.[431]

The origins of such sections could be traced back to s.75 of the *Companies Act 1928*

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[428] **Section 213. Fraudulent Trading**
"(1) If in the course of winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper."

[429] **Section 993. Offence of Fraudulent Trading**
"(1) If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence.
(2) This applies whether or not the company has been, or is in the course of being, wound up.
(3) A person guilty of an offence under this section is liable–
(a) on conviction on indictment, to imprisonment for a term not exceeding ten years or a fine (or both);
(b) on summary conviction–(i) in England and Wales, to imprisonment for a term not exceeding twelve months or a fine not exceeding the statutory maximum (or both);
(ii) in Scotland or Northern Ireland, to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum (or both)."

[430] **Section 458. Punishment for Fraudulent Trading**
"If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose every person who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or fine or both.
This applies whether or not the company has been or is in the course of being, wound up."

[431] *Morphitis v Bernasconi,* (2001) WL 825267 (Chancery) at para 78 (available WL UK) [*Morphitis*] (revsd without discussion of this point sub nom *Morphitis v Bernasconi,* [2003] WL 270900 (CA) (available WL UK), [2003] EWCA Civ 289, [2003] Ch 552 [*Morphitis CA*]

through s.275 of the *Companies Act 1929* and s.332(3)[432] of the *CA 1948*.[433] The civil remedy for fraudulent trading was at s.630[434] in the *CA 1985* (now s.213 of the *IA 1986*).

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[432] **Section 332. Responsibility for fraudulent trading of persons concerned**
(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.
On the hearing of an application under this subsection the official receiver or the liquidator, as the case may be, may himself give evidence or call witnesses.
(2) Where the court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration, and in particular may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any company or person on his behalf, or any person claiming as assignee from or through the person liable or any company or person acting on his behalf, and may from time to time make such further order as may be necessary for the purpose of enforcing any charge imposed under this subsection.
For the purpose of this subsection, the expression "assignee", includes any person to whom or in whose favour, by the directions of the person liable; the debt, obligation, mortgage or charge was created, issued or transferred or the interest created, but does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any
of the matters on the ground of which the declaration is made.
(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in subsection (1) of this section, every person who was knowingly a party to the carrying on of the business in manner aforesaid, shall be liable on conviction on indictment to imprisonment for a term not exceeding two years or to a fine not exceeding five hundred pounds or to both.
(4) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made, and where the declaration under subsection (1) of this section is made in the case of a winding up in England, the declaration shall be deemed to be a final judgment within the meaning of paragraph (g) of sub-section (1) of section 1 of the Bankruptcy Act 1914."

[433] 'Table of Derivation" online <http://www.bailii.org/uk/legis/num_act/1985/ukpga_19850006_en.pdf> at 616

[434] **Section 630. Responsibility of individuals for company's Fraudulent Trading**
"(l) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
(2) The court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may if it thinks proper to do so, declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are to be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.
(3) On the hearing of the application, the official receiver or the liquidator (as the case may be) may himself give evidence or call witnesses.
(4) Where the court makes such a declaration, it may give such further directions as it thinks proper for giving effect to the declaration; and in particular, the court may:
(a) provide for the liability of any person under the declaration to be a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in a mortgage or charge on assets of the company held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf, and
(b) from time to time make such further order as may be necessary for enforcing any charge imposed under

The separation in the *CA 1985* of the sections comprising the criminal offence and civil liability derived from the fact that there could be a prosecution and conviction for fraudulent trading in regard to a company whether or not the company had been or was in the course of being wound up (s.993 of the *CA 2006* & s.458 of the *CA 1985*). Such had been made clear by amendment to s.332(3) of the *CA 1948*.[435] The Cork Committee recommended changes to s.332.[436]

Section 213 of the *IA 1986* and s.458 of the *CA 1985* (now s.993 of the *CA 2006*) are essentially identical with the primary difference being procedure. The former requires a civil standard of proof, namely the balance of probabilities whereas the standard for the criminal proceedings under s.458 (now s.993) remains beyond reasonable doubt.[437] There are also differences with regard to the court order and the fact that, with s.458 (now s.993), there is no need for the company to be in liquidation.[438] However, s.213 applies only in winding up (regardless of whether or not the company is insolvent).

Under the predecessors of s.213 (s.630 of the *CA 1985* and s.332 of the *CA 1948*), a creditor or a contributory as well as the liquidator could bring applications. Section 213 now makes it clear that the only applicant would be the liquidator and that court orders would provide for payment to the company to swell its assets for the benefit of creditors generally.[439] An order under the section does not provide for adjustment of creditors'

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this subsection.
(5) For purposes of subsection (4), "assignee"
(a) includes a person to whom or in whose favour, by the directions of the person made liable, the debt, obligation, mortgage or charge was created, issued or transferred or the interest created, but
(b) does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any of the matters on the ground of which the declaration is made.
(6) This section has effect notwithstanding that the person concerned may be criminally liable in respect of matters on the ground of which the declaration under subsection (2) is to be made and where the declaration is made in the case of a winding up in England and Wales, it is deemed a final judgment within section l(1)(g) of the Bankruptcy Act 1914."

[435] *Morphitis, supra* note 431 at para 79

[436] Cork Report, *supra* note 6 at para 1778 (According to Cork Report s.332 created a civil and personal liability as well as a criminal offence. The constituent elements of the two were identical because of which courts refused to entertain a civil claim absent dishonesty and were applying a criminal standard of proof to civil cases)

[437] Keay & Doyle, *supra* note 313 at 229

[438] Keay, *Responsibilities to Creditors*, *supra* note 85 at 27

[439] Civil liability attracts compensation. It is not penal. Same consequences as in wrongful trading

rights between themselves save to the extent that the respondent party to the fraudulent trading is also a creditor. In that context there is a provision, at s.215(4) of the *IA 1986*, to order that the company's debt to the respondent should rank subsequent in priority to all other debts owed by the company. That is an incident of putting right the fraudulent trading.[440] There is no punitive element in the amount of any contribution under s.213(2).[441] An individual creditor who is defrauded in carrying on the business of the company has his individual remedy under the general law.[442]

R. C. Williams states that the need for a statutory remedy for victims of corporate fraud arose as a result of the inadequacy of the common law.[443] The remedy at common law if the company is insolvent or if the tort could not be imputed to the company is an action for damages in the tort of deceit against the individual by whom the victim is deceived. Such an action involves technical and evidentiary difficulties (proof of subjectively dishonest intention, necessity to prove representation, if pertaining to creditworthiness of the company then under the law of United Kingdom it needs to be in writing and signed by the representor), which often make the prospects of success rather poor. So long as the company is able to pay its debts the victim of fraud could sue the company in contract or tort. The need of an action against the controllers of the company rather than against the company itself usually arises when a company is insolvent.[444] Williams states that despite its shortcomings the availability of a common law action for deceit should not be overlooked.[445]

It is clear from reading the section that any sums ordered to be paid must go to the general funds in the hands of the liquidator and be held for the benefit of the whole body of creditors. Thus, the mechanics of this remedy directly benefit creditors. It is a specific creditor protection mechanism under English corporate law.

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[440] *Morphitis, supra* note 431 at para 81& 82
[441] *Morphitis CA, supra* note 431 at para 55
[442] *Morphitis CA, supra* note 431 at para 47
[443] RC Williams, "Fraudulent Trading", (1986) 4 Company and Securities Law Journal 14 at 15 [Williams]
[444] Williams, *supra* note 443 at 15
[445] Williams, *supra* note 443 at 15

3.13 "Intent to defraud" or "fraudulent purpose"

The central element of fraudulent trading is "an intent to defraud" or "fraudulent purpose". These words have received conflicting interpretations. It has been stated in the literature that these words appear to have created two distinct offences, namely fraudulent trading with intent and fraudulent trading with the intention of achieving certain objectives.[446] The first reported decision to address this issue was *Re William C. Leitch Bros Ltd*.[447] The Court of Appeal in *R v Grantham*[448] provided clarification by citing Maugham J in *Re Leitch (William C) Bros Ltd*[449] as saying: "In my opinion I must hold with regard to the meaning of the phrase "carrying on business with intent to defraud creditors" that if a company continues to carry on business to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is in general a proper inference that the company is carrying on business with intent to defraud, . . ."[450] The court also considered *R v Sinclair*[451] in which the jury was directed with the following instructions to find "intent to defraud": "It is fraud if it is proved that there was the taking of a risk, which there was no right to take, which would cause detriment or prejudice to another. You have to be sure that it was deliberate dishonesty."[452] The court rejected that the defendant had to prove that he knew at the time when debts were incurred that there was no reasonable prospect of creditors ever receiving payment of their debts. It was enough if the defendant realized at the time when the debts were incurred that there was no reason for thinking that funds would be available to pay the debt when it would become due or shortly thereafter.[453] These words import a criterion that is partly subjective and partly objective. Thus, in order to establish dishonesty under s.213 of the *IA 1986* the court must find that:

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[446] Williams, *supra* note 443 at 26
[447] *Re William C Leitch Bros Ltd.,* (No.1) [1932] Ch 71 (Ch D) at 77
[448] *R v Grantham,* [1984] BCLC 270 (CA, Criminal Division) [*R v Grantham*] (*R v Grantham* involved an unsuccessful appeal against a criminal conviction for fraudulent trading, under s.322 of Companies Act 1948 which as the predecessor of s.213 created criminal offence as well as imposed civil penalties in respect of fraudulent trading)
[449] *Re Leitch (William C) Bros Ltd.,* [1932] Ch 71
[450] *R v Grantham, supra* note 448 at 274
[451] *R v Sinclair,* [1968] 1 WLR 1246
[452] *R v Grantham, supra* note 448 at 276
[453] *Morphitis, supra* note 431 at 91

(i) According to the ordinary standards of reasonable and honest people what was done was dishonest and

(ii) That the actor himself must have realized that the act was by those standards dishonest.[454]

Thus, based on the test, the words "defraud" and "fraudulent purpose" connote actual dishonesty.[455] But it has been pointed out that a defendant may not be dishonest if he performs some act "as of right".[456] Such an act would not be considered dishonest by the standards of ordinary reasonable people. Similarly, a defendant holding a subjective belief that he is acting lawfully would not be thought dishonest by ordinary standards.[457] Thus, there is room to negate an "intent to defraud" based on unfounded optimism. Such an interpretation defeats the purpose of the fraudulent trading provision by shielding the very conduct in question. It also raises several complex and unresolved questions such as: Is there a positive duty on a director to investigate the grounds for his belief? Or is mere ignorance of the company's financial prospects coupled with lack of grounds for suspicion sufficient to negate fraud? If there is a duty to investigate must it be done personally by the director? Would it be reasonable to rely upon the assurances of other directors, advisers or employees? Must a director bring to an investigation a level of experience? What would be the position of directors who are absent from board meetings when the relevant decisions are made or who register a dissenting vote?[458]

One also needs to be mindful that the court exercises its powers under s.213 of the *IA 1986* when it appears that "any business of the company has been carried on with intent to defraud creditors of the company". Parliament did not provide that the powers under the section might be exercisable whenever it appears to the court "that any creditor of the company has been defrauded in the course of carrying on the business of the company." There is wisdom behind the fact that Parliament did not enact the section in those terms

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[454] *Morphitis, supra* note 431 at para 95 & 96 (referred as Ghosh test)
[455] Halsbury's Laws of England, vol 7(4) *Company and Partnership Insolvency*, 4th ed. (London: LexisNexis, 2004) at para 911 FN 4
[456] *Morphitis, supra* note 431 at para 97
[457] *R v Clowes,* [1994] 2 All ER 316
[458] Williams, *supra* note 443 at 25

because otherwise whenever any creditor is defrauded in the course of carrying on business it would follow that the business is being carried on with intent to defraud creditors which is a wide statement.

There is a general recognition in the literature that successful resort to s.213 is rare because of the complexity in proving an intention to defraud. The courts have also not been helpful in formulating a precise test. As one academic comments: "there has been a lack of consistency over the years in the judicial approach to formulating a proper test for fraudulent conduct to be applied under s.213 and its statutory antecedents".[459] In my view, this may be a serious setback to the potential use of this provision. England has been upfront in bringing its corporate law into accord with the needs of the time for the sake of consistency and enhancing the confidence of investors. Given the importance of these provisions for creditors, it may be desirable to have these complexities removed. That said, regardless of the shortcomings of the fraudulent trading provision, English creditors have "wrongful trading" as a remedy which is wide enough to even include fraudulent trading.[460] English creditors are still better off than their Canadian counterparts who have to rely on flawed legal mechanisms to seek relief if their interests are jeopardized.

3.14 At whom the fraudulent intent or purpose directed?

Section 213 of the *IA 1986* has been interpreted by some judges to include not only "frauds" directed at suppliers who were convinced to give, to their detriment, credit to a company but also potential customers, who may or may not be contingent creditors, should they have been left with a claim against the company. In *R v Kemp*[461]*,* the Court of Appeal held that the mischief of s.332 of the *CA 1948* includes the phrase "carrying on of the business of the company for any fraudulent purpose". These words the court found are wide enough to include customers of that company. In this case, the appellant through

[459] Anne Savirimuthu, "Morphitis in the Court of Appeal: some reflections" (2005) 26(8) Comp Law 245 at 245 (citation omitted)
[460] See chapter 5
[461] *R v Kemp,* [1988] BCLC 217

two limited companies performed a number of frauds involving misrepresentations to customers that they ordered and were obliged to accept carbon paper, which in fact they had not so ordered. The defrauded customers did not pursue any civil remedies against the appellant. But an indictment specifying two counts of fraudulent trading was preferred against the appellant under s.332(3) of the *CA 1948*. The indictment contained no reference to creditors. The statutory words relied on by the prosecution were "or for any fraudulent purpose". The appellant submitted that there was no case against him as s.332(3) was limited to offences involving creditors of the company whereas those defrauded were customers. The court rejected his submission and held that a defrauded customer is merely a potential creditor. This case and other case law discussed herein are examples of abuses of corporate form to which creditors become victim, especially in situations of insolvency or near it if not adequately protected.

3.15 Knowingly "parties to the carrying on of the business"

For a successful claim under s.213, all the components need to be present i.e., the "act", the element of "knowing", the "intent or purpose" and the "being concerned in the doing of the act".[462] With regard to "knowingly", it may be disputable as to what constitutes "knowledge". An important preliminary question is who are the parties that require knowledge?

It seems to be implicit from case law that the phrase "parties to the carrying on of the business" refers only to those persons exercising powers of management.[463] This case again highlights the risks that creditors face and the consequent need to sufficiently protect their interests in situations when they are most vulnerable. This notion, however, became murky with the decision in *Re Gerald Cooper Chemicals Ltd.*[464] In that case, Jimlou Ltd provided £150,000 to Gerald Cooper Chemicals Ltd for installation of an indigo production plant. Jimlou Ltd had two directors and Gerald Cooper Ltd had only one director C. C had to repay Jimolu Ltd's loan by June 30, 1976 (which was extended

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[462] Williams, *supra* note 443 at 29
[463] *Re Maidstone Buildings Provisions Ltd.,* [1971] 3 All E R 363 at 368
[464] *Re Gerald Cooper Chemicals Ltd.,* [1978] 2 All E R 49 [*Gerald Cooper*]

later). C's plan was to repay that loan out of profits of the business. However, the financing became short and, by end of July 1976, Gerald Cooper Ltd became insolvent. Gerald Cooper Ltd however received advanced payments for indigo sales from customers and one such payment of £125,698 was received on August 19 from Harrisons Ltd. C used £100, 000 to pay Jimlou Ltd in part discharge of its debt of £150,000 and then went into liquidation.

Harrisons Ltd applied for a declaration under s.332(1) of the *CA 1948* alleging that the respondents Jimlou Ltd and each of its two directors were knowingly parties to the carrying on of the business of Gerald Cooper Ltd with intent to defraud creditors and for other fraudulent purposes. They alleged that when C accepted advanced payment he had no intention to carry out the order but his intention was to repay Jimlou Ltd. They claimed that C defrauded Harrisons Ltd by paying Jimlou Ltd and that the respondents knowing of the circumstances were parties to the fraud as they accepted the said sum and thus were responsible to pay back Harrison Ltd. The respondents claimed that there was no cause of action against them as they could not knowingly be parties because they had neither powers of management or control over the carrying on of the business of Gerald Cooper Ltd nor did they assist in it.

The court held that Gerald Cooper Ltd carried on its business with intent to defraud Harrisons Ltd knowing that it could not supply the indigo and would not be able to repay the said amount of £125,698. With regard to the liability of respondent directors of Jimlou Ltd, the court held that a creditor would be regarded party to the carrying on of a business with intent to defraud other creditors if he accepts money with knowledge of the fraud.[465] The court's decision in this case provides an important extension of the scope of the phrase "parties to the carrying on of the business" as well as explaining all the other components of s.213 succinctly. In Canada, this may also be relevant. As noted, it is not restricted just to the directors but anyone who is knowingly party to fraudulent trading. Therefore, the potential net of persons against whom creditors may seek a remedy through the liquidator is wide under this mechanism.

[465] *Gerald Cooper, supra* note 464 at 53

Another case that adds to the jurisprudence of fraudulent trading in a unique way is *Morphitis v Bernasconi*.[466] The facts of this case highlight how the privilege of limited liability may be abused in the hands of corporate managers to the detriment of its creditors. It also sheds light on the role and effect of legal advice on the conduct of proceedings against directors. The case arose from fraudulent trading allegations against two directors (M & B) of Transmetal Chimica Ltd (TMC). TMC was incorporated in 1983. It ran a haulage business and was the tenant of a warehouse and depot premises under four leases from Ramac Holdings Ltd (Ramac). The leases were between 12 and 20 years duration. TMC remained unprofitable during 1992. By June 1992 management accounts showed an excess of liabilities over assets in the sum of £27, 275. M and B identified the onerous rental obligations under existing leases as the company's principal commercial problem which were exacerbated by an upwards only rent review. They took legal advice as to whether and how they could free TMC from liabilities under the said leases while preserving its name, assets, good will and trade connections. Following two legal opinions, they implemented a scheme. Pursuant to the scheme, M and B resigned from the board of TMC in December 1992 and a new director was appointed to manage its business. M and B incorporated a new company (Newco) to purchase the goodwill of TMC. The business was thereafter carried on from the new premises, using the same initials TMC by Newco. This was done pursuant to counsel's advice so that the leases could be disclaimed as onerous property by the liquidator upon the insolvent winding up of TMC. The only problem with this arrangement was the potential for criminal proceedings against M and B pursuant to s.216 of the *IA 1986*. The section creates a criminal liability for a person who was a director of the company at any time within 12 months of its liquidation if, within five years of liquidation, such person was involved in a company or business using the liquidated company's name or one similar to it. Thus, for Newco to adopt the TMC initials by circumventing the legal provision, it was necessary that TMC should continue to trade for a further period of 12 months after the incorporation of Newco. From January 1993, TMC operated purely as lessors of trailers to Newco.

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[466] *Morphitis, supra* note 431

It is worth keeping in mind that this was all carried out with management's knowledge that TMC was now insolvent. The rent received from Newco was used to generate income for the following 12 months period in order to pay trade creditors (particularly Ramac) and prevent it from filing any potential writ in respect of unpaid rent or a petition for insolvent winding up. However, TMC's lawyers advised management to delay and stall rent payments. The purpose of stalling was to smoothly end the required 12 months period by just making sufficient payments to Ramac to ensure it did not take any action (The said 12 month period started when TMC commenced trading as hauler and was due to expire on 23rd December 1993). In September 1994, Ramac finally made a statutory demand for outstanding rent. The demand was unsatisfied and, on a winding up petition by Ramac, TMC was compulsorily wound up on December 20 1994. The liquidator was appointed on March 3, 1995. The liquidator took proceedings against B and M under s.213 of the *IA 1986* alleging that they and the company's solicitors had been party to the carrying on of the business of TMC with intent to defraud creditors, namely the landlord. The liquidator's case at trial was that Ramac was deceived into a belief that it would be paid the full sums under the leases in due time or within an agreed rescheduling time "when at all times the respondents knew or intended that no monies would be paid after 23rd December 1993 and it was that deception which constituted "fraudulent trading"". The respondents denied carrying on the business of the company to defraud creditors of the company or for any other fraudulent purpose. They denied any knowledge of stalling. The solicitors made a payment into court and a s.213 claim proceeded to trial against the directors only. The court held that there had been fraudulent trading by the directors but that their liability to make contribution to the company's assets, including a punitive element, had been satisfied by the solicitors' payment into court. The liquidator appealed and the directors cross-appealed.[467]

Lord Justice Chadwick of the Court of Appeal allowed the directors' cross appeal and dismissed the liquidator's appeal. It was held that a business could have been carried on with intent to defraud creditors notwithstanding that only one creditor had been defrauded and by a single transaction but s.213 was not engaged in every case where an individual

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[467] *Morphitis v Bernasconi*: no punitive element in contribution for fraudulent trading (2003) Co L N 4 at 8

creditor had been defrauded but only where the business of the company had been carried on with intent to defraud. The facts of this case matches the Cork Committee's remarks of the need to protect the public and creditors by disqualifying those directors who easily let a company become insolvent and then form another company leaving behind a trail of unpaid creditors, and are often found repeating such behaviour with impunity.[468] Needless to say, cases like *Morphitis* illustrate the need to have effective creditor protection.

The Court of Appeal provided a new twist in the interpretation of s.213. The Court did not treat the phrase "with intent to defraud" as a composite whole but instead defined the word "intent" in isolation. Hence, no intent to defraud was identified since the "aim" or "objective" underlying TMC's trading was not to defraud but rather to avoid liability under s.216 of the *IA 1986*. This reasoning is distinguishable from what was held in *Re Gerald Cooper Chemicals Ltd*[469] in which the defrauding of a single creditor by a single transaction was described as "carrying on a business to defraud creditors". Instead, the Court of Appeal in *Morphitis* specifically stated that " . . . Section 213 is not engaged in every case where an individual creditor has been defrauded. The section is engaged only where the business of the company has been carried on with intent to defraud."[470]

The Court of Appeal made another confusing statement at paragraph 55: "I accept that the dishonesty which the judge found deserved criticism but for my part, I can not see that it compounded (or was compounded by) dishonesty which the judge did not find to have been made out." Thus, in one instance the judge appears to recognize that there was some dishonesty and in another instance negates that.[471] The directors' thorough reliance on legal advice may have contributed hugely to a judgment in their favour which reflects the importance of expert legal advice which directors would willingly seek once there is fear of personal liability.

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[468] See para 3.11 above
[469] *Gerald Cooper, supra* note 464
[470] *Morphitis CA, supra* note 431 at para 47
[471] *Morphitis CA, supra* note 431 at para 55

To sum up, my analysis of the fraudulent trading provision reveals a rather restrictive judicial reasoning. Also, it suffers some problems of interpretation that need attention and the onus of proof is also heavier. It has been on the statute book for more than 80 years but so far it appears to have been invoked in only 73 cases (based on a Westlaw search). The scarcity of case law gives the impression that civil actions brought to enforce s.213 of the *IA 1986* are very much long shots. However, that is not necessarily the case. It might be simply because there is less reason now for liquidators to invoke it due to the availability of wrongful trading[472] which has a less onerous standard of proof and is wide enough to include all cases of fraudulent trading perpetrated by directors. Also, the consequences under both provisions are the same.[473] However, that is not the end of s.213 which has been used lately more where allegations are made against other parties provided they are knowingly parties to the fraudulent trading as was the case in *Re Gerald Cooper Chemicals*.[474] Some may argue that the provision has failed to have a profound effect in England but there is no empirical evidence to support that. We have to understand the spirit of the law and not just its letter or how much it is applied. These provisions are there for a purpose which is to protect interests of creditors at the hands of directors. Legal remedies such as fraudulent trading go a long way in keeping creditor interests safe by having a positive impact on directors' decision making. Their mere presence is enough to create that effect as they create a culture of responsibility in the ranks of management. In Canada, there are no fraudulent or wrongful trading sort of provisions that English creditors enjoy. In my analysis, a wrongful trading type of duty would be sufficient to protect creditors in Canada. However, according to my literature review, Canada is more tilting towards American models lately. As I said in chapter 2 Dickerson Committee in its amendments to *CBCA* followed the US Model Business Corporations Act but also retained some distinctive British provisions e.g., oppression.[475] Thus, there are provisions in the *CBCA* that have English roots. Nevertheless, considering this inclination, I shall next examine Delaware corporate law to see if Delaware has any

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[472] Discussed under part II of chapter 3
[473] Sealy & Milman, *supra* note 357 at 203
[474] *Gerald Cooper, supra* note 464
[475] See para 2.1 above

legal mechanisms like England that could be imported to strengthen Canada's unsatisfactory creditor protective legal regime.

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UNITED STAES (DELAWARE)

4.1 Introduction

The *Delaware General Corporation law*[476] (*DGCL*) was revised with major amendments on July 3, 1967.[477] The Delaware statute applies to stock and non-stock corporations and to business and non-profit (including charitable and religious) corporations. Delaware corporation law is different from statutes in other states which treat separately various classes of corporations usually on account of business and non-profit.[478]

Delaware corporate law is distinctly flexible compared to any other state in the U.S.A. It is constantly evolving as it is based on equitable principles and is judge made. Some may argue that this is a positive sign considering the changing environment and norms in which businesses operate. In my view, it only creates uncertainty and confusion, as it is difficult to keep up with the changing case law. The complexity of business issues require a balance especially with regard to fiduciary duty jurisprudence and not a "race to the bottom"[479] kind of approach for which Delaware is notoriously famous. I may mention that William Cary who coined this term examined substantive law issues and the Delaware court. He determined that Delaware has created a legal climate favourable to management and sometimes harmful to shareholders in order to generate revenue from corporate taxes. In Cary's view, Delaware used corporate law rules that disregard shareholders' interests to attract managers responsible for incorporation decisions. He concluded that substantive federal regulation of corporations' internal affairs was necessary to protect shareholders from exploitation by mangers. As is evident from Cary's theory he viewed corporate law as the only source of protection for shareholders.

[476] It is state law being the law governing the internal affairs of the corporations
[477] Ernest L Folk, III, "*The New Delaware Corporation Law*" (International Printing Company: 1967); also *Delaware Code* Annotated, Title 8 online at Westlaw US
[478] Edward P. Welch and Andrew J. Turezyn, *Folk on the Delaware General Corporation Law: Fundamentals* (New York: Aspen Law & Business, 2000) at 2 [Folk]
[479] Donald, *supra* note 4 at 177 (at 180 it states that race to bottom is influenced to attract charters to their state in order to produce significant revenues)

Ralph Winter identified this flaw in the “race for the top” theory. Winter argues that state charter competition benefits shareholders by driving states to adopt corporate law rules that enhance shareholder value. Pointing to the existence of market forces that check management opportunism he, law and economics scholars and others have rejected the conclusions of Cary’s race for the bottom theory. State competition for corporate charters is thus, not a race for the bottom but for the top i.e., states vie for incorporation business by offering corporate law rules that maximize shareholder value. Delaware’s dominance is thus attributable to its adoption of optimal rules by these scholars.[480]

4.2 Overview of directors’ fiduciary duties

Chapter 1, Title 8 of the *Delaware Code* contains *DGCL*. Its Sub-chapter IV lays down provisions in detail for “Directors and Officers.” Section 141 provides requirements for board of directors, their powers, numbers, qualifications, terms and quorum, committees, classes of directors, etc. Section 141(a)[481] specifically requires that, in the absence of a special provision in the certificate of incorporation, the directors rather than the shareholders manage the business and affairs of the corporation.

In discharging this function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders[482] which require that they act prudently and in the best interests of the corporation rather than in their own interest. The source of Delaware fiduciary duty law is entirely based on common law. The Delaware Court of Chancery

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[480] Lucian Arye Bebchuk, “Federalism and the Corporation: The desirable limits on state competition in corporate law” (1992) 105 Harv L Rev 1435 at 1444 & 14445

[481] **Section 141(a)** “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.”

[482] *Revlon Inc. v MacAndrews & Forbes Holdings Inc.,* 506 A 2d 173 (Del Sup Ct 1985) at 179; *Aronson v Lewis,* 473 A 2d 805 at 811 (Del Sup Ct 1984); *Guth v Loft, Inc*., 5 A 2d 503(Del Sup Ct 1939) at 510

and the Supreme Court of Delaware apply principles of fiduciary duty on a case-by-case basis.[483]

Several cases have described directors' fiduciary duties in a triad fashion i.e., care, loyalty, and good faith.[484] In 2006, the Delaware Supreme Court made clear that the duty of good faith is a subsidiary element of the duty of loyalty.[485] The duty of care and duty of loyalty are traditional hallmarks of a fiduciary who endeavors to act in service of the corporation and its stockholders. Each of these duties is of equal and independent significance.[486] These duties are similar to Canada in the sense that Canada also imposes two distinct duties: a fiduciary duty or duty of loyalty requiring honesty and good faith and a duty of care. However, in Canada, the said duties are only owed to the corporation not to stockholders or any one else.

In Delaware, the duty of loyalty is a broad and encompassing duty that, in appropriate circumstances, imposes a special obligation upon a director in any of his relationships with the corporation. It embodies both an affirmative duty to protect the interests of the corporation and an obligation to refrain from conduct that would injure the corporation. The violations of the duty of loyalty may include fraud, bad faith and self- dealing.[487]

In *Cede v Technicolor, Inc*. (*Cede*)[488] the Delaware Supreme Court reiterated the traditional view of duty of loyalty in broad and unyielding terms:

> "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . a public policy, existing

[483] Pamela L J Huff & Russell C Silberglied, "From Production Resources to Peoples Department Stores: A similar response by Delaware and Canadian courts on the Fiduciary duties of directors to creditors of insolvent companies" (2007) 1 J Bus & Tech L 455 at 459 (Footnote no. 15) [Pamela]

[484] *Emerald Partners v Berlin*, 787 A.2d 85, 90 (Del Sup Ct 2001); see also *Malone v Brincat*, 722 A 2d 5, 10 (Del 1998); *Cede & Co. v Technicolor, Inc*., 634 A 2d 345, 361 (Del Sup Ct 1993) (*Cede*), modified, 636 A 2d 956 (Del Sup Ct 1994). But see *Guttman v Huang*, 823 A 2d 492, 506 n.34 (Del Ch 2003) (criticizing the use of this triadic description of fiduciary duties and suggesting that only two duties (due care and loyalty) are necessary because good faith is a subset of loyalty)

[485] *Stone ex rel AmSouth Bancorporation v Ritter*, 911 A 2d 362, 369-70 (Del Sup Ct 2006), 2006 WL 3169168 (Del Sup Ct)

[486] *Cede, supra* note 484 at 367

[487] Folk, *supra* note 478 at 78-79

[488] *Cede, supra* note 484

> through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest."[489]

According to Folk, "under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in s.141(a) of the *DGCL*, that the business and affairs of a Delaware corporation are managed by or under its board of directors.[490] This view is confirmed in *Cede* wherein the court essentially confirmed that, "the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[491]

The duty of care arises in two contexts. First, directors must exercise the requisite degree of care in the process of decision-making and act on an informed basis.[492] Second, directors must also exercise due care in other aspects of their responsibilities, including their delegation functions. According to some authors[493] before the 1980s, the director's duty of care in general received little or no notice in Delaware. Directors were presumed (all but conclusively) to have behaved as reasonable persons would. They claim that after 1985 the duty of care emerged as a stand-alone independent enforceable obligation against directors and one of the three categories of fiduciary duty.[494] Delaware imposes the "ordinarily prudent person" standard of care by common law and not by statute.[495] This standard is tempered by the business judgment rule, a common-law doctrine under which courts have generally refused to second-guess a business decision so long as the

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[489] *Cede, supra* note 484 at 361
[490] Folk, *supra* note 478 at 89
[491] *Cede, supra* note 484 at 361, also West Headnote 11
[492] *Smith v Van Gorkom*, 488 A 2d 858 (Del Sup Ct 1985) at 872 & 873 [*Van Gorkom*]
[493] William T. Allen, Jack B. Jacobs & Leo E. Strine Jr, "Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law" (2001) 26 Del. J. Corp. L 859 at 862 [Allen]
[494] Allen, *supra* note 493 at 862
[495] Fletcher Cyc, *supra* note 50 at § 1032 (citations omitted)

management made a reasonable effort to make an informed decision.[496]

"The rule operates as both a procedural guide for litigants and a substantive rule of law. As a rule of evidence, it creates a presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company."[497] In *Cede*[498] the rule is worded as follows:

> "A plaintiff challenging a board decision has the burden at the outset to rebut the rule's presumption. To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty good faith, loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the "entire fairness" of the transaction to the shareholder plaintiff."[499]

It was held that the rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation.[500] Thus, *Cede* implies that courts may second guess directors decisions only if the plaintiff discharges their burden of rebutting the presumption. It seems Delaware has come a long way from its insulating (or what one may call deferential) policy for directors' liability for negligence to meaningful procedural and substantive review of their decision-making. One academic is of the view that *Cede* has opened the door for the fishing expeditions that the rule was meant to prevent.[501] Thus, *Cede* confirms the relevancy of the business judgment rule as a standard of review.[502] The rule however, is still in evolution.

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[496] Fletcher Cyc, *supra* note 50 at § 1029
[497] *Cede*, *supra* note 484 at 360
[498] *Cede*, *supra* note 484
[499] *Cede*, *supra* note 484 at 361
[500] *Cede, supra* note 484 at 360
[501] Stephen M Bainbridge, *Corporate Law*, 2nd ed. (Foundation Press, 2009) at 102 [Bainbridge]
[502] Bainbridge, *supra* note 501 at 103

To seek refuge under the rule, the directors may be required to prove if the presumption is successfully rebutted by the plaintiff that they informed themselves prior to making a business decision of all material information reasonably available and by acting with requisite care in the discharge of their duties. In Delaware, the directors' duty to exercise an informed business judgment is in the nature of a duty of care[503] and gross negligence is the standard applied to such judgment.[504] In *Smith v Van Gorkom*[505] (*Van Gorkom*), in the context of a merger case it was held that making an uninformed decision to sell the company by relying on an oral presentation of the plan without an adequate study of what the company's stock is worth, even where market price is substantially below merger price, may be characterized as grossly negligent at least where no copies of the merger agreement were distributed and no director got to read the agreement before approval of the plan. Thus, *Van Gorkom* established procedural or process due care as a prerequisite for invoking the business judgment rule. The Delaware precedents interpret the requirement of due care as being limited to adequacy of decision-making process.[506]

The business judgment rule is complex and, on the surface, it might seem that there is some tension between the business judgment rule which absolves directors for all but gross negligence and the duty most states impose on directors to exercise the care that an ordinarily prudent person would exercise under similar circumstances (as stated above Delaware imposes the "ordinarily prudent person" standard by common law).[507] However, these two rules stand side-by-side. When applying the duty of care, courts focus their inquiry on management's efforts in arriving at the decision rather than on the wisdom of the decision itself. When applying the business judgment rule, the courts do not protect decisions where the directors exercised little care in reaching the decision. The two rules, thus, work together to ensure that the substance of a business decision will be immune from challenge but if, and only if, the directors were diligent in making their

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[503] *Van Gorkom*, *supra* note 492 at 872
[504] *Van Gorkom*, *supra* note 492 at 873
[505] *Van Gorkom, supra* note 492
[506] *Brehm v Eisner*, 746 A 2d 244 (Del Sup Ct 2000) at 264 [*Brehm*] ("Due care in the decision making context is *process* due care only)
[507] Fletcher Cyc, *supra* note 50 at § 1032 (citations omitted)

decision.[508] The business judgment rule protects the directors of solvent, barely solvent and insolvent corporations.[509]

This may be contrasted with Canada where judicial non-interference is limited to business decisions that are made honestly, prudently, in good faith and on reasonable grounds.[510] The case law however, provides that it does not mean that a business decision honestly made should not be subjected to examination at all but that it should not be subjected to microscopic examination.[511] The business judgment rule forms part of the Canadian corporate law and serves partly as an evidentiary presumption.[512] However, the exact nature of the rule is disputed. A recent example of its application comes from *Peoples* where the SCC described the Canadian business judgment rule in the following words:

> "Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. Business decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the "business judgment rule", adopting the American name for the rule."[513]

The SCC explained the rule's formulation in the following words (citing *Maple Leaf Foods Inc. v Schneider Corp.*,[514] an earlier 1998 Ontario Court of Appeal decision):

> "The court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within a range of reasonableness, the court ought not substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's

[508] Fletcher Cyc, *supra* note 50 at § 1036
[509] *Trenwick America Litigation Trust v Ernst & Young LLP*, 906 A 2d 168 (Del Ch 2006) at 195 FN75
[510] *Corporacion Americana de Equipamientos Urbanos S L v Olifas Marketing Group Inc.,* 2003 CarswellOnt 3186 at para 14 (SCJ) (WL Can) (citation omitted) [*Corporacion Americana*]
[511] *Corporacion Americana, supra* note 510 at para 13
[512] Halsbury's Canada, *supra* note 32 at HBC-229
[513] *Peoples SCC, supra* note 10 at para 64
[514] *Maple Leaf, supra* note 55 at para 36

> determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision. This formulation of deference to the decision of the Board is known as the "business judgment rule." The fact that alternative transactions were rejected by the directors is irrelevant unless it can be shown that a particular alternative was definitely available and clearly more beneficial to the company than the chosen transaction."[515]

From reading the above two paragraphs, one gets a very strong message of the court's deference to board decisions. Thus, substantive review would be lacking.

The SCC further held that, for successfully challenging a business decision, it must be established that the directors acted (i) in breach of the duty of care and (ii) in a way that caused injury to the plaintiff.[516] The onus, thus, is placed on the plaintiff. The SCC cited this idea from an article[517] by W.T. Allen, J.B Jacobs and L.E. Strine, Jr. in which the authors have spoken against any need for directors to prove that they did not cause injury. The authors are highly critical of *Cede* and are of the view that, if the plaintiff proves that board's conduct was grossly negligent liability should follow. The SCC, however, did not explain if a business decision would be reviewed as suggested in the said article or by the method of rebuttable presumption laid down in *Cede*. Prof. Nicholls is of the view that the same sort of presumption does not appear to form part of the Canadian business judgment rule.[518] I, however, note that in an Ontario court decision of 2003,[519] the judge stated that: "it is a precondition to the application of the rule that the court must determine that the directors have acted honestly, prudently, in good faith and on a reasonable belief that the transaction is in the best interest of the company."[520] The judged further stated that "the business judgment rule is in addition in my view a "presumption" only which can be rebutted by evidence which may cast doubt as to the honesty, prudence, and good faith of the directors in approving or entering into the

[515] *Peoples SCC, supra* note 10 at 65 (citation omitted)
[516] *Peoples SCC, supra* note 10 at para 66 (the SCC referred this from an Article by W.T. Allen wherein the author has spoken against director proving that they did not cause injury
[517] *Peoples SCC*, *supra* note 10 at 66 (citation omitted)
[518] Nicholls, *Corporate Law*, *supra* note 124 at 306
[519] *Corporacion Americana, supra* note 510
[520] *Corporacion Americana, supra* note 510 at para 13

challenged transaction."[521] However, the SCC in *Peoples* chose to cite *Maple Leaf Foods Inc. v Schneider Corp.,*[522] which has not used the word "presumption" at all. To me, this speaks highly about the policy or direction that the SCC has in mind for the business judgment doctrine in Canada. It seems from *Peoples* that, Canadian directors have no burden to prove the substance of their business decisions which explains the ruling in *Peoples*. The SCC in *Peoples* did not state how the preconditions to the application of the business judgment rule were satisfied. There is thus, confusion regarding the direction and application of this rule. Hence, there is a need to protect creditors further in Canada so that directors won't risk their interests with impunity.

Under Delaware law, an agreement restricting a director's exercise of his fiduciary duties is invalid.[523] However, s.102(b)(7)[524] of the *DGCL* allows *inter alia* a corporation to set forth in the certificate of incorporation a provision eliminating or limiting the personal liability of a director of the corporation for monetary damages for breach of duty of care as a director. The corporation is not so allowed to eliminate or limit the liability of a director for any breach of the director's duty of loyalty to the corporation or its stockholders for acts or omissions not in good faith, intentional misconduct or knowing violation of law. Section 102(b)(7) was added to *DGCL* in 1986.[525] It states that any such provision in a corporation's articles will relieve a director of personal liability for breach of duty of care but, if the court finds the breach to rise to a breach of duty of loyalty, then this provision will have no effect. Any breach of duty of loyalty is not protected under the business judgment rule.

By its terms, s.102(b)(7) does not apply to fiduciaries other than directors in respect to a corporation or its stockholders. However, courts lately have taken the view that a

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[521] *Corporacion Americana, supra* note 510 at para 14
[522] *Maple Leaf, supra* note 55
[523] Folk, *supra* note 478 at 76
[524] **Section 102(b)(7).** "A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under s.174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit ..." (irrelevant portion excluded)
[525] Folk, *supra* note 478 at 15

provision modeled on *DGCL* s.102(b)(7) may apply and shield directors from liability for breach of the duty of care owed to creditors of an insolvent company.[526]

4.3 Expansion of directors' duties

No statutory statement of directors' fiduciary duties to creditors exists in the *DGCL*. However, it has now been established in Delaware (through *Angelo, Gordon & Co v Allied Riser Communications Corporation*[527] and other cases[528]) that the directors of an insolvent[529] corporation owe a fiduciary duty to creditors when the corporation is insolvent. The content of such duty is sporadically discussed in cases where the issue of creditors' derivative and direct standing to sue has been raised. Section 327[530] of the *DGCL* sets out the derivative action. It is apparent from a plain reading of that provision that only stockholders are allowed to bring a derivative action. In fact, s.327 does not create the right to sue derivatively but is restrictive of that right.[531] Also, it appears from the title of that section that the aim of the legislature was to give this right only to stockholders. It may be pertinent to mention that, although s.327 is the only statutory provision dealing with derivative actions, these suits are also controlled by the Rules of the Court of Chancery and by case law doctrine. Chancery Court Rule 23.1[532] sets forth

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[526] *Production Resources Group, LLC v NCT Group, Inc*. 863 A 2d 772 (Del Ch 2004) (*Production Resources*)
[527] *Angelo, Gordon & Co v Allied Riser Communications Corporation,* 805 A 2d 221 (Del Ch 2002)
[528] *McDonald v Williams,* 174 US 397 (1899), 19 S Ct 743 (1899) (*McDonald*); *Geyer, supra* note 9 and *Credit Lyonnais*, *supra* note 9
[529] In that case it was its balance sheet insolvency
[530] **Section 327 of DGCL: Stockholder's derivative action; allegation of stock ownership**
"In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law."
[531] *Harff v Kerkorian,* 324 A 2d 215 (Del Ch 1975) at 218 (*Harff Del Ch*)
[532] **Rule 23.1: Derivative actions by shareholders**
(a) In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort (Delaware Code Annotated, online at Westlaw under Delaware Rules of Court sub-heading Chancery Court Rules, Paragraph IV-Parties)

the procedure for instituting a derivative action. Creditors are not statutorily entitled to bring a derivative action.

The derivative suit in Delaware, just like other common law jurisdictions, is a remedy for an injury to the corporation; e.g. breach of fiduciary duties. Its meaning is two-fold: "(1) It is the equivalent of a suit by the stockholders to compel the corporation to sue (2) It is a suit by the corporation asserted by the stockholders on its behalf, against those liable to it."[533] "The relief obtained in the action is relief to the corporation in which all stockholders, whether guilty or innocent share indirectly".[534] "The derivative action was developed by equity to enable stockholders to sue in the corporation's name where those in control of the corporation refused to assert a claim belonging to the corporation."[535]

The decision in *Harff v Kerkorian*[536] (*Harff*) is significant as it recognized creditors' standing to bring a derivative claim under the Delaware jurisprudence. The Court of Chancery made it clear that, "unless there are special circumstances which affect the right of the debenture holders as creditors of the corporation, e.g., fraud, insolvency or a violation of a statute, the rights of the debenture holders are confined to the terms of the indenture agreement pursuant to which the debentures were issued."[537] It may be mentioned that debenture holders are recognized as creditors of the corporation.[538] The court further pronounced that, outside of the exceptions, no fiduciary duties exist between corporate directors and holders of convertible subordinate debentures. The Supreme Court of Delaware reversed the Chancery Court decision finding fraud to support claim for breach of fiduciary duty by directors for alleged wrongful declaration of dividend. This led academics to speculate on the possible existence of a fiduciary duty to creditors outside of the special circumstances recognized by the Delaware Chancery Court in its decision. Chancellor Berger V.C in *Norte & Co v Manor Healthcare Corp*.[539] made the following critical analysis of the Delaware Supreme Court's treatment of *Harff*:

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533 *Harff v Kerkorian*, 347 A 2d 133 (Del Sup Ct 1975) at 218 (*Harff Sup Ct*)
534 Rules of Court of Chancery, rule 23; *Taormina v Taormina Corp,* 78 A.2d 473 (Del Ch 1951) at 476
535 *Harff Sup Ct, supra* note 533 at 218
536 *Harff Sup Ct*, *supra* note 533
537 *Harff Del Ch*, *supra* note 531 at 222
538 *Norte & Co. v Manor Healthcare Corp.*, 1985 Del. Ch. LEXIS 526 at 526 (*Norte*)
539 *Norte, supra* note 538

> "Nowhere in the *per curiam* decision by the Supreme Court in *Harff* is there a discussion of the viability of a breach of fiduciary duty claim. The Court noted the holding below as well as the lower court's finding that plaintiffs had failed to allege fraud in their complaint. The Supreme Court held that, "fraud is sufficiently asserted to require trial of that issue…." and remanded "on the issue of fraud." The Supreme Court's choice of language strongly suggests that it was not disturbing the trial court's holding that convertible debenture holders may not state a claim for breach of fiduciary duty. Moreover, given the fundamental distinctions between stockholders and creditors, highlighted above, I must assume that the Supreme Court would have explained the basis for its holding if it had determined that plaintiffs had standing to maintain a breach of fiduciary duty claim."[540]

A decade later, in *Simons v Cogan*[541] (*Simons*), the Supreme Court of Delaware clarified the confusion surrounding its holding in *Harff* by stating specifically that it should not be read to support the inference that, under Delaware law, a fiduciary duty is owed to debenture holders absent fraud, insolvency or violation of statute.[542] Incidentally, in *Simons*, the Supreme Court of Delaware concurred with the Court of Chancery's decision that the debenture holder's complaint failed to plead facts constituting actionable fraud.

In *Geyer v Ingersoll Publications Co.* (*Geyer*)[543], it was held that an insolvency exception arises when a corporation is insolvent in fact. In that case, a corporate creditor sued the corporation and its director for breach of fiduciary duties and fraudulent conveyances with the result that the corporation was rendered insolvent and unable to pay its debt to the creditor. The Chancery Court confirmed that a "corporate director will owe fiduciary duties to corporation's creditors whenever it is "insolvent in fact" even though no statutory proceedings (e.g., bankruptcy) have been filed against it." In the Court's view, the existence of fiduciary duties at the moment of insolvency causes directors to choose a course of action that best serves the entire corporate enterprise rather than any single group.[544] *Geyer's* reasoning is often confused with *Asmussen v Quaker City Corp* (*Asmussen*)[545] wherein the court held that bankruptcy proceedings were necessary to

540 *Norte*, *supra* note 538 at 14 (citation omitted)
541 *Simons v Cogan,* 549 A 2d 300 (Del Sup Ct 1987) (*Simons*)
542 *Simons*, *supra* note 541 at 303
543 *Geyer, supra* note 9
544 *Geyer, supra* note 9 at 789
545 *Asmussen v Quaker City Corp.,* 156 A 180 (Del Ch 1931)

establish fiduciary duties to creditors as to claims that the directors unjustly preferred one creditor to another.[546]

The Court of Chancery's opinion in *Credit Lyonnais Bank Nederland v Pathe Communications* (*Credit Lyonnais*)[547] created confusion when the court highlighted that "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[548] The case involved a leveraged buyout (LBO) of MGM-Pathe Communication Co., (MGM) by Pathe Communications Corp (PCC) (MGM's parent company and 98.5% shareholder of MGM) and Credit Lyonnais Bank Nederland (CLBN) (the principal lender in the transaction). The transaction failed to meet its sponsors' expectations and, after only 5 months of the acquisition, trade creditors forced MGM into bankruptcy.[549] To improve its health, a management reorganization was carried out and corporate governance and other agreements were executed with CLBN. The bankruptcy proceedings were dismissed on May 28, 1991 by a further loan injection. However, after the expiration of the appeal time, a battle to control the company erupted which ultimately led to the removal of 3 board members by CLBN on June 16, 1991. The removal of these directors was challenged *inter alia* in this case.

It is important to understand that the goal of a LBO is value realization and, thus, stockholders greatly benefit whereas other corporate constituents, especially bond holders and long-term employees, are put at risk because, if the LBO fails, it could lead to bankruptcy with its accompanying realization of financial loss. The court found that neither the management team nor CLBN breached its fiduciary duty or duty of good faith and fair dealing owed to PCC. The court in its deliberations stated that: "in these circumstances where the company was in bankruptcy until May 28 and even thereafter the directors labored in the shadow of that prospect, Mr. Ladd and his associates were appropriately mindful of the potential differing interests between the corporation and its

[546] *Geyer, supra* note 9 at 788
[547] *Credit Lyonnais, supra* note 9
[548] *Credit Lyonnais, supra* note 9 at 34
[549] PCC closed its purchase of substantially all of the stock of MGM on November 1, 1990 but MGM in an accounting sense became financially distressed within weeks.

98% shareholder."[550] Following this observation, the court made its landmark remark that, when a corporation is operating in the vicinity of insolvency, a board of directors is not merely agent of shareholders but owes duty to the corporate enterprise. Academics have read this statement widely and it stirred a debate among scholars as a definite extension of the content of the fiduciary duty. In my view, this statement should not be read as enlarging the scope of the directors' fiduciary duty considering the specific facts of this case (being an LBO transaction). The statement in consideration only affirms the established jurisprudence of the Delaware courts that, in managing the business and affairs of a corporation that is in the vicinity of insolvency, directors should act in the best interests of the corporation and its shareholders. The later decisions of that court have cleared the impact created by this statement. I however, found that it is still quoted extensively in the literature much *albeit* as a reference point only in my view.

Credit Lyonnais, however, affirmatively established the significance of the elusive zone of insolvency for creditors by granting them, for the first time, a right to assert direct fiduciary duty claims. But it acknowledged the zone's existence for creditors. It is to be compared with *Gheewalla* wherein the Delaware Supreme Court altogether eliminated directors' duties to creditors of a company operating in the zone of insolvency.[551] Could it be because the zone of insolvency has become so difficult to define that Delaware has moved away from recognizing the zone's fuzzy existence? The Delaware Supreme Court has in fact further complicated any understanding of this zone by stating that directors' duty does not shift in a solvent corporation operating in the zone of insolvency.[552] Arguably, a corporation in the zone of insolvency could not be solvent. Thus, the bottom line is to have more legal mechanisms similar to wrongful trading provisions to protect creditors interests' as apparently the current ones are just not enough to cover all issues facing creditors in or near insolvency.

[550] *Credit Lyonnais, supra* note 9 at 34
[551] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 101
[552] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 101

4.4 But when exactly is a corporation insolvent?

Interestingly, this zone of insolvency question is haunting all the three jurisdictions under my study and no one has come up with any answers. Prof. Nicholls has rightly used the expression "Zeno's paradox" for it.[553] Perhaps future case law will be able to solve this paradox (I shall comment upon this more as the context permits in the remaining half of this chapter). These unresolved issues highlight the importance of more creditor protection.

Specifically, in Delaware corporate law there are no uniform tests to determine solvency. Its solvency tests originate from common law jurisprudence and the tests are inconsistently defined and applied.[554] Generally, Delaware courts have defined insolvency in two ways.[555] First, a company is insolvent if it is unable to pay its debts as they fall due in the usual course of business.[556] Second, a company may be insolvent if it has liabilities in excess of a reasonable market value of the assets held.[557] The former is referred to as the cash flow test and the latter as the balance sheet test.

In *Geyer*[558]*,* the Delaware Court of Chancery deliberated on the question as to when directors' fiduciary duties to creditors arise; i.e. upon existence of "insolvency in fact" or when a party institutes bankruptcy proceedings. The Court noted that, in *McDonald v Williams*[559]*,* it was held that the fact of insolvency was relevant in raising directors' duties to creditors and not the initiation of bankruptcy proceedings.[560] It was also observed that, in *Bovay v H. M. Byllesby & Co.* (*Bovay*)[561], the court defined a

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553 Christopher C Nicholls, "Liability of Corporate Officers and Directors to Third Parties" (2001) 35 CBLJ 1 at 34

554 Robert J Stearn Jr & Cory D Dandestin, "Delaware's Insolvency Test: What is it and Does it make sense? A comparison of solvency tests under the bankruptcy Code and Delaware Law" (2011) 36 Del J Corp L 165

555 *Gheewalla (Del Ch), supra* note 9 at 10

556 *Geyer, supra* note 9 at 789

557 *Geyer, supra* note 9 at 789*;* also *McDonald, supra* note 528 (defining an insolvent corporation as one in which the value of its assets has sunk below the amount of its debts)

558 *Geyer, supra* note 9

559 *McDonald, supra* note 528

560 *Geyer supra* note 9 at 788

561 *Bovay v H M Byllesby & Co.,* 38 A 2d 808 (Del Sup Ct 1944) at 813

corporation as insolvent when the value of its assets sunk below the amount of its debts.[562] The Delaware Court of Chancery in *Geyer* concluded its analysis as follows:

> "Two factors lead me to conclude that insolvency means insolvency in fact rather than insolvency due to a statutory filing in defining insolvency for purposes of determining when a fiduciary duty to creditors arise. The first and more important factor is that Delaware case law requires this conclusion. Indeed one case explicitly states that "[t]he fact which creates the trust [for the benefit of creditors] is the insolvency, and when the fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency."[563]

The court further deliberated:

> "Besides Delaware case law, the other factor upon which I rely in holding that the insolvency exception arises upon the fact of insolvency rather than the institution of statutory proceedings is the ordinary meaning of the word insolvency. An entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets . . . Although there may be other definitions of insolvency that are slightly different, I am not aware of any authority which indicates that the ordinary meaning of the word insolvency means the institution of statutory proceedings."[564]

The Delaware courts, however, have been unable to set forth a precise definition of what constitutes the "zone of insolvency"[565]. The Supreme Court of Delaware in *Gheewalla* stated that, when a solvent corporation is operating in the zone of insolvency, the directors' fiduciary duty belongs to the corporation and its shareholders but, when it is insolvent, creditors have standing to bring derivative actions against directors on behalf of the corporation for breaches of fiduciary duties.[566] Such statements create the impression that the "zone of insolvency" is somehow distinct from "insolvency" but provide no more in terms of explanation. The distinction, thus, is not clear.

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[562] *Geyer, supra* note 9 at 788
[563] *Geyer, supra* note 9 at 787 (citations omitted)
[564] *Geyer*, *supra* note 9 at 789 (citation omitted)
[565] *Gheewalla (Del Sup Ct), supra* note 9 at 98, FN 20
[566] *Gheewalla (Del Sup Ct), supra* note 9 at 101

Academics have also given their own interpretations to the "zone of insolvency" question. For example, Nancy A. Peterman and Sherri Morissette view the "zone of insolvency" as a concept to account for shifting and expanding of a board of directors' fiduciary duties when a company is entering a time of financial crisis.[567] This, in my view, makes sense because courts in Delaware have held that fiduciary duties to creditors arise when a corporation is "insolvent in fact" rather than when a party initiates formal bankruptcy proceedings.[568] Thus, it may be correct to say that by the time a corporation would file for bankruptcy it likely has been in and passed through the zone of insolvency and is now deemed insolvent.[569] While the so-called "zone of insolvency" has not been clearly defined, it is clear that whether a company is within that zone would be a fact-intensive inquiry by the board of directors.[570] From the perspective of a director whose company is in financial difficulty, the foremost problem would be to figure out by which criteria this undefined zone of insolvency (also referred to as "vicinity of insolvency" or "insolvency in fact") would be determined and, once this is determined, the second tough question facing him would be what fiduciary duties are owed and to whom.

4.5 Conceptual clarifications

From a review of *Gheewalla*, it is clear that the case was used as a channel to clarify the rights of creditors in the zone of insolvency as well as to remove some of the confusion created by earlier jurisprudence. In *Gheewalla*[571] the issue before the court was whether a creditor, North American Catholic Educational Programming Foundation Inc. (NACEPF), of Clearwire Holdings Inc. (Clearwire) could maintain a direct claim against the directors of Clearwire for their alleged breach of fiduciary duty while the company was either insolvent or in the zone of insolvency on the grounds that the directors should

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[567] Nancy A. Peterman & Sherri Morissette, "*Director's Duties in the Zone of Insolvency: The Quandary of the Nonprofit Corp"* (2004) 23-MAR Am Bankr Inst J 12 [Nancy]; also *Credit Lyonnais, supra* note 9 at 34 ("[W]here a corporation is operating in the "vicinity of insolvency", a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."); *Brandt v Hicks, Muse & Co.,* (*In re Healthco Int'l, Inc.*), 208 B R 288, 300 (Bankr D Mass 1997) ("When a transaction renders a corporation insolvent, or brings it to the "brink of insolvency", the rights of creditors become paramount.").
[568] *Geyer, supra* note 9 at 787
[569] Nancy, *supra* note 567
[570] Nancy, *supra* note 567
[571] *Gheewalla, supra* note 9

have preserved Clearwire's assets for NACEPF.

NACEPF sought only a direct claim for breach of fiduciary duties relying wholly on the Delaware Chancery Court's earlier decisions in which creditors were allowed direct claims in the context of both insolvency and the zone of insolvency. In particular, it relied on *Credit Lyonnais* (arguing that the challenged conduct is similar to the hypothetical conduct illustrated in foot note fifty five of that decision) and *Production Resources* (alleging that the defendants' conduct constitutes the sort of self dealing found actionable under that decision). NACEPF waived all rights to pursue a derivative action.[572]

The defendants contended that Delaware jurisprudence recognizes only a derivative claim in the context of insolvency or the vicinity of insolvency and not direct claims. They argued that the Delaware Chancery Court's opinion in *Production Resources* on which NACEPF placed significant reliance acknowledged only the possibility of such a direct claim by creditors.

The court accordingly framed its analysis as follows:

1. Whether a direct claim asserted by creditors of a corporation in the zone of insolvency is cognizable under the Delaware law?
2. Whether a direct claim asserted by creditors of a corporation in insolvency is cognizable under the Delaware law?

To answer the above issues the Chancery Court referred to *Tooley*[573] where it was held that standing of a creditor must be determined based on the following criteria:

(i) Who suffered the alleged harm the corporation or the individual stockholder?
(ii) Who would receive the benefit of the recovery?

The court noted that, in order to assert a direct claim, not only does the above standard

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[572] *Gheewalla (Del Ch)*, *supra* note 9 at 8
[573] *Tooley v Donaldson, Lufkin & Jenrette, Inc.,* 845 A 2d 1031 (Del Sup Ct 2004)

have to be met but also the claim must be cognizable under the Delaware jurisprudence. The court acknowledged that, under the Delaware jurisprudence, creditors are not allowed fiduciary duty claims against corporate directors unless the corporation is insolvent.

With regard to the first question, the court clarified that its dicta in *Credit Lyonnais* was read too widely and out of context. The Delaware Chancery Court had stated that: "where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[574] The court explained that this statement was interpreted by some commentators (and jurisdictions) as suggesting the existence of a cognizable claim for relief which may be asserted by creditors. The court extrapolated that the "creative language in a famous footnote in *Credit Lyonnais* was read more expansively by some . . . to expose directors to a new set of fiduciary duty claims, this time by creditors . . . [S[ome read *Credit Lyonnais* as authorizing creditors to challenge directors' business judgments as breaches of fiduciary duty owed to them . . . however the court's language is perhaps better viewed merely as a shield for directors from stockholder claims in this context."[575] In other words, the court emphasized that its statement in *Credit Lyonnais* did not mean to extend any direct duties to creditors and so, under Delaware jurisprudence, a direct claim by creditors of a corporation in the zone of insolvency would be defeated on that basis.

The Delaware Chancery Court acknowledged that derivative claims by creditors of an insolvent corporation are generally accepted as a practical matter. The court recognized that the idea that an insolvent corporation's creditors (having been effectively placed in the shoes normally occupied by the shareholders – that of residual risk bearers) should be granted standing has significant intuitive and persuasive merit because they are the principal remaining constituency with a material incentive to pursue derivative claims on behalf of the corporation.[576] The court stated that "[i]n contrast to stockholder and creditor derivative actions, direct claims by creditors would not help the corporate

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[574] *Credit Lyonnais, supra* note 9 at FN 34
[575] *Gheewalla (Del Ch), supra* note 9 at 11, FN 105
[576] *Gheewalla (Del Ch)*, *supra* note 9 at 12

collective because the benefit would accrue to the creditor bringing the direct claim. Any marginal benefit of such enforcement effort potentially accruing to the corporate collective would likely be outweighed by the disruption of the established corporate governance mechanism."[577] This residual risk bearer concept is the same as recognized in other common law countries such as England and Canada. England has incorporated legal mechanisms specific to creditor needs but Canada lacks such protective measures.

The Chancery Court noted that NACEPF failed to produce any evidence or case law to assert a direct claim. It stated:

> "Indeed it would appear that creditors' existing protections among which are the protections afforded by their negotiated agreements, their security agreements, the implied covenant of good faith and fair dealing, fraudulent conveyance law and bankruptcy law render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary. Moreover any benefit to be derived by the recognition of such additional direct claims appear minimal at best and significantly outweighed by the costs to economic efficiency. One might argue that an otherwise solvent corporation operating in the "zone of insolvency" is one in most need of effective and proactive leadership as well as the ability to negotiate in good faith with its creditors goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."[578]

The court explained its reasoning by giving the example of start-up firms which often remain in a zone of insolvency until their business establishes. Thus, the court considered it potentially negative to innovation to expand liability through individual direct claims for breach of fiduciary duties.[579] I agree with the Chancery Court's observations. In my view, it would be against the established corporate governance paradigm to give creditors direct standing. However, that doesn't undermine the need to provide creditors protection through other legal means. On the one hand, it is acknowledged that they are the principal remaining constituency in an insolvent corporation and, on the other hand, there is a concern about innovation of start-up firms. Is this a balanced approach? Equity demands

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[577] *Gheewalla (Del Ch), supra* note 9 at 12
[578] *Gheewalla (Del Ch)*, *supra* note 9 at 13
[579] *Gheewalla (Del Ch), supra* note 9 at 13 FN 123

fairness and creditors should be fairly and adequately protected. England has come up with several specific legal mechanisms that are recognized by its corporate statute to address creditors interests (wrongful trading, fraudulent trading, directors disqualification orders under *CDDA 1986* in the context of wrongful and fraudulent trading and on the ground of unfitness).[580]

The Chancery Court, thus, refused NACEPF's direct standing for breach of fiduciary duties as creditors of a solvent corporation operating in the zone of insolvency.

The Court of Chancery then proceeded to consider whether a direct claim was possible against the defendant directors for not preserving the assets of Clearwire once it became apparent that Clearwire would not be able to continue as a going concern; i.e. when it became apparent that it was actually insolvent. To ascertain the position of Delaware case law, the Court re-visited its earlier jurisprudence in *Production Resources* and *Big Lots Stores*.

In *Production Resources*, the defendant's motion to dismiss the plaintiff-creditor's fiduciary duty claim was denied in part on the "conservative assumption that there might, possibly exist circumstances in which directors (of an actually insolvent corporation) display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they would expose themselves to a direct fiduciary claim by that creditor."[581] Arguably, that was one decision in which the Delaware Court of Chancery rejected any bright line test for determining whether claims are derivative or direct when brought by the creditor of an insolvent corporation. However, having done that, the Court of Chancery declined to offer a definite statement of law for policy reasons. The plaintiff had proved derivative standing so the court felt it unnecessary to delve further into that question. The court, however, made the remark that it was not prepared to rule out the possibility that the alleged conduct against the plaintiff might

[580] See my comments on minimum capital requirements in chapter 5. As said here start-up firms remain in zone of insolvency. To neutralize the effect it may have on creditors if business fails there is need for some wrongful trading kind of legal mechanism.
[581] *Gheewalla (Del Ch), supra* note 9 at 14

support a limited direct claim.[582]

In *Big Lots Stores,*[583] in dismissing the plaintiff's direct claim for breach of fiduciary duty, a two-prong test was developed for determining whether a creditor could have a direct claim for breach of fiduciary duty in the insolvency context. It was held that the creditor must demonstrate that he is entitled to payment and the entitlement is either currently or imminently due.[584]

In *Gheewalla,* the Chancery Court assumed *arguendo* that a plaintiff's direct claim could potentially be asserted directly. It, however, failed to find the same because NACEPF's complaint could not satisfy the first test laid down in *Big Lots Stores.*[585] The Court of Chancery accordingly dismissed it for failing to state a claim. NACEPF appealed before the Supreme Court of Delaware.

The Supreme Court of Delaware rejected *arguendo* assumptions framed by its lower court and instead declared that it has never recognized a creditor's right to assert a direct claim for breach of fiduciary duty against the directors of an insolvent corporation. The court acknowledged the difficulty in giving directors' duties to creditors by saying that "[t]o recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it and the newly recognized direct fiduciary duty to individual creditors."[586] Thus, the Supreme Court of Delaware conclusively closed the door on questions that arose out of contentious opinions/dicta issued by its lower court.

The legal significance of *Gheewalla* is that there now is a conclusive statement from the highest court of Delaware confirming that corporate directors do not owe a direct fiduciary obligation to creditors of a corporation but that:

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[582] *Gheewalla (Del Ch)*, *supra* note 9 at 14
[583] *Big Lots Stores,* 2006 WL 846121
[584] Meaning invidious conduct towards a particular "creditor" with a "proven entitlement to payment"
[585] *Gheewalla (Del Sup Ct), supra* note 9 at 102
[586] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 103

(1) Such duty is owed to the corporation and its shareholders.[587]
(2) When a corporation is solvent fiduciary duties are enforceable by shareholders who have standing to bring derivative actions on behalf of the corporation.[588]
(3) When a corporation is insolvent creditors have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.[589]
(4) Recoveries are owed to the corporation on a derivative action.
(5) Directors' duty does not shift in a solvent corporation operating in the zone of insolvency.[590]
(6) Individual creditors of an insolvent corporation could pursue derivative claims on its behalf or any other direct non-fiduciary claim just as shareholders could when it is solvent.[591]

The Delaware Supreme Court was guided by the following objectives in its ruling in this case:

> "The need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[592]

The judgment has resolved some outstanding issues by clarifying existing case law but it nevertheless fails to explain the zone of insolvency. I wonder how far this judgment has actually protected creditors? Isn't it advisable to have more legal mechanisms than looking for practical solutions for creditors? John Pearch and Ilya Lipin posit that this

[587] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 101
[588] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 100
[589] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 100 & 102
[590] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 100
[591] *Gheewalla (Del Sup Ct)*, *supra* note 9 at 102
[592] *Gheewalla (Del Sup Ct), supra* note 9 at 101 & 103

ruling suggests a legal trend of eliminating and limiting the directors' fiduciary duties to creditors while in the zone of insolvency.[593] However, that zone is nothing but a fuzzy period of heightened uncertainty. As said before, this is the dilemma in all the three jurisdictions I studied. Many academics view this ambiguity harmful to business decision-making as it could increase transaction costs in the shape of directors' risky decisions and encourage creditors to pursue inventive ways to claim recovery.[594] This is precisely the reason to legislate and come up with legal solutions in order to remove all these unnecessary ambiguities. It is worth remembering that proof of insolvency is not the threshold for institution of wrongful trading proceedings.[595] It is easier for a liquidator who in the course of liquidation develops reasonable knowledge of all the relevant facts to pursue a wrongful trading action. The amounts realized on the disposal of assets provides further guidance as to their value at the relevant date. Thus, it is not difficult for him to establish insolvency for the purpose of wrongful trading. It is an ingenious solution to protect creditors' interests.

4.6 Exceptions to direct standing

The general rule, as I stated above, is that directors do not owe creditors direct fiduciary duties. However, *Production Resources*[596] (decided by the Chancery Court before Supreme Court's opinion in *Gheewalla*) has been an exception to the said rule. In that case, a plaintiff creditor obtained judgment against the defendant for $2 million but failed to seek recovery. The plaintiff proved that the insolvent defendant avoided payment to the judgment creditor and misused his corporate power for self-benefit. The Delaware Court of Chancery allowed the creditor standing to bring a direct claim because he was the only one who had been injured and was thus the only one to whom recovery was due.

The court noted that "evaluating a creditor's claim that directors have breached fiduciary duties owed to the firm involves no novel inquiry as the court could draw deeply on the

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[593] John A Pearch II & Ilya A Lipin, "The Duties of Directors and Officers within the Fuzzy Zone of Insolvency" (2011) 19 Am Bankr Inst L Rev 361 at 374 [Pearch]

[594] Pearch, *supra* note 593 at 369

[595] See para 3.10 above

[596] *Production Resources, supra* note 526

principles that apply in typical derivative cases. The extent of fiduciary obligations directors owe in their dealings with specific creditors of insolvent firms is a far less settled matter. In general, equity is reluctant to create remedies when adequate legal remedies already exist."[597] The Court of Chancery regarded its decision to permit the plaintiff's direct claim to continue in *Production Resources* as tentative only.[598] This, in my view, speaks to the Supreme Court of Delaware's position in *Gheewalla* that the Court of Chancery has never recognized that a creditor has a direct right to claim breach of fiduciary duty against directors of an insolvent corporation.

To summarize this chapter, Delaware has not codified fiduciary law which does not provide consistency and that is why we have seen some conflicting court decisions that I have discussed above. In a solvent corporation navigating in the zone of insolvency in Delaware the directors owe their fiduciary obligations to the corporation and its shareholders. However, when a corporation is insolvent its creditors take the place of the shareholders.[599] *Gheewalla* has thus, given some relief to creditors by extending fiduciary duties when the corporation is insolvent. Creditors of an insolvent corporation could accordingly bring a derivative action against directors on behalf of the corporation to enforce breach of fiduciary duties. Delaware Supreme Court has now moved away from the zone of insolvency by not recognizing its existence in *Gheewalla*. By extending fiduciary duties to creditors, Delaware recognizes that with the company's insolvency directors face perverse incentives under a shareholder primacy rule. Directors in Delaware have the advantage of the business judgment rule but it is a double-edged sword. Directors are protected provided they have not breached their fiduciary duties. If a breach is proved, they face substantive review of the entire fairness of the transaction. The business judgment rule in the Delaware jurisprudence, however, is pretty complex and still evolving.[600] Delaware has not incorporated more legal mechanisms like the wrongful trading provisions in England. I, therefore, could not find anything that I would

[597] *Gheewalla* (Del Ch), *supra* note 9 at 14 FN 132
[598] *Gheewalla* (Del Ch), *supra* note 9 at 14
[599] *Gheewalla* (Del Sup Ct), *supra* note 9, West headnote 8
[600] It is commonly believed that it stands as a hurdle in holding directors personally responsible for failures in decision-making and thus, encourages risky behavior. However, academics agree that cases like *Cede* and *Van Gorkom* have gutted this doctrine in Delaware. It still is a defence to directors.

suggest for import to Canada to strengthen its deficient creditor protection. On the contrary, wrongful trading provisions as in England could potentially serve Canadian creditor interests better. The Delaware approach in not recognizing creditor interests is based partly on considerations of economic efficiency as suggested by the Chancery Court in *Gheewalla* whereas the English approach in recognizing creditor interests is based on commercial morality. England has taken a fair, just and balanced stand that is most likely to maximize overall competitiveness, wealth and welfare for all as well as drive long term company performance and efficiency. As stated by the CLR, "[t]he basic goal for the directors should be the success of the company for the benefit of its members as a whole; but that to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers and in the community more widely."[601] It may be arguable as to which model is better. However, I resonate with England's inclusive approach to economic efficiency over Delaware's approach to economic efficiency.

[601] Cm 6456, *supra* note 205 at para 3.3

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FINAL ANALYSIS

This final chapter contains my research findings and argues that the risks to which creditors are exposed at the hands of corporate directors demand protection. As I said in the first chapter, directors have incentives to encourage the company to continue to trade when insolvent[602] or financially distressed. These incentives are varied and may relate to saving their position, to avoid reputational loss arising from business failure or to maximize value of their own shares (in private companies often directors are also major shareholders) but these incentives primarily arise due to the limited liability[603] of the company under which shareholders enjoy all the benefits of risky activities but are not personally responsible for its debts. Hence, there is an incentive for directors to continue to trade to protect their own and the shareholders' interests knowing that, if the company is already on the verge of insolvency, the downside risk would fall wholly on the creditors while the upside benefit may get the company out of distress. Thus, creditor interests are directly at stake if directors knowingly continue to trade when a company is insolvent or on the verge of insolvency as the excessive risky actions that directors may take at such a crucial time could seriously reduce the assets of the company.[604] Thus, the possibility exists that creditors may not be able to recover their debt. Paul L Davies puts this risk in the following words: "the little person, whom the law should particularly protect, rarely has any idea of the risks being run when granting credit to a company with a high sounding name, impressive nominal capital . . . and with assets mortgaged up to the hilt."[605]

I mentioned earlier and my research suggests that the potential for wrongful trading is

[602] See FN 1
[603] See FN 4
[604] Because creditors cannot recover from shareholders personally, their only resort for recovering their money back would be from the liquidation of assets if it were insolvent. It is therefore important that a company that is approaching insolvency or is already there has sufficient assets to pay back its creditors. Hence, need to protect their interests so that directors won't risk them. Otherwise, creditors claim will remain unsatisfied.
[605] Gower, *supra* note 189 at 37

greater in a close or private corporation as there is less separation between management and shareholders since shareholders tend to be the main decision makers. Therefore, there is no monitoring of management's actions if this kind of wrongful trading occurs. Unfortunately, there is no specific provision in the Canadian corporate statutes requiring directors' to consider creditor interests as part of their duties to the company when the company might be insolvent or financially distressed such as wrongful trading provisions in England.[606] The absence of any such provision has exposed creditor interests to unjust risks at the hands of directors. There is a burgeoning need to adopt more legal measures as a remedy to protect their interests. That is why I reviewed the available legal mechanisms in England and Delaware to see if Canada could import any provisions from there to improve its lax creditor protection. I may state, at the outset, that I am struck with the rigorous improvements to corporate statutes, available remedies and enforcement mechanisms adopted in England for creditor protection in the recent past. It is sad that Canada considered law reforms to directors' duties but rejected them as unnecessary.[607] In my view, Canada should seriously re-think its corporate law policy in accordance with the needs and demands of the time and wrongful trading provisions as in England (or a similar version) could be a good starting point.

I found interesting the differences in the three jurisdictions. In England, I found cases holding, obiter dicta, that a duty of directors to creditors of a corporation when insolvent or on the verge of insolvency exists.[608] I also found other cases that specifically rejected any such duty.[609] I noted that English law gives no standing to creditors individually or collectively to redress a breach of any such alleged duty. In England, there is a shift in the content of the duty of loyalty to creditors by directors of insolvent companies but the duty is owed only to the company.[610] I also found that England has incorporated provisions in its law designed to protect creditors of corporations that are financially distressed or on

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[606] See chapter 2 above
[607] Ed Waitzer & Johnny Jaswal, "*Peoples*, *BCE* and the Good Corporate "Citizen"", (2009) 47 Osgoode Hall L J 439 at 479
[608] See FN 194
[609] See FN 267 & 269
[610] Reinier Kraakman et al, *The Anatomy of Corporate Law*, 2nd ed. (Oxford University Press, 2009) at 151

the verge of insolvency.[611] The provisions are variously labelled and each impose *ex pos*t liability. The most notable of these provisions is wrongful trading which in effect creates a duty of care to creditors by directors, enforceable by the liquidator, to take all reasonable steps to minimize potential loss to the company's creditors once there is no reasonable prospect of the company avoiding insolvent liquidation. I have discussed wrongful trading at length in Part II of chapter 3. I have also discussed fraudulent trading which is based on dishonesty as opposed to negligence, enforceable by the liquidator, against directors or any person to make a contribution if knowingly involved in defrauding creditors (or indeed for any fraudulent purpose). The doctrine of wrongful trading, however, is wide enough to include all cases of fraudulent trading. That said, the fraudulent trading provision still has relevance to creditors and is an important protection considering it applies to any type of winding up and not just insolvency. I have discussed fraudulent trading in Part III of chapter 3. These two provisions play a major role in directors' disqualification on the grounds of unfitness under the *CDDA 1986.* The provisions under the *CDDA 1986* do not have any monetary benefit for creditors but the threat of disqualification against directors who take on risks that are unreasonable for creditors may have a profound effect on the choice of decisions that directors take in or near insolvency.[612] As I said in chapter 3,[613] the intention of the provisions under the *CDDA 1986* is to penalize those who abuse the privileges of limited liability by operating one-man, insufficiently capitalized companies and not to deter legitimize enterprise. These are strong thought provoking objectives.

I found that, in England, the business judgment rule[614] was considered yet the CLR rejected it as a formal requirement of English law. Regardless of the business judgment rule the wrongful trading provision has its built in defence and exact standard of care in the presence of which the business judgment rule's application seems plausible. The same goes with the *CDDA 1986*, which uses a gross standard of care for evaluation of conduct thereunder.

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[611] Section 214 of the *IA 1986* discussed in chapter 3 part II, s.213 of the *IA 1986* discussed in chapter 3 part III, disqualification of directors under the *CDDA 1986* discussed in para 3.11

[612] Davies, *supra* note 4 at 91

[613] See para 3.11 above for the *CDDA 1986*

[614] See para 3.6 above for business judgment rule

I discovered that in Delaware, like England, there is a shift in the content of directors' duty of loyalty to creditors in relation to insolvent firms. However, in contrast to England where corporate legislation includes specific creditor regarding provisions, Delaware's fiduciary duty law is based on the statutory requirements of *DGCL* and the judge made principles that form the standards of conduct of directors. Hence, there is no wrongful, trading sort of provisions in Delaware (there is fraudulent conveyance law but not in the corporate statute). Some may find Delaware's approach dynamic but, in my view, it lacks consistency and also becomes confusing. The *Credit Lyonnais* case is one such example which was explained in a different light by the Delaware Supreme court and the Delaware Chancery court in *Gheewalla*. I also noted that older cases recognized creditors' direct standing to sue directors for breach of fiduciary duty in insolvency but, in the recent case of *Gheewalla*, the Supreme Court of Delaware has altogether rejected those decisions. The only remedy for creditors is a derivative action. The recovery of such action is owed to the corporation. Delaware corporate law does not lay down any uniform tests to determine insolvency. The business judgment rule is an important part of Delaware jurisprudence on directors' fiduciary duties. The Delaware courts apply the duty of care and business judgment rule side-by-side. When applying the duty of care, courts focus on management's efforts in arriving at the decision rather than its wisdom. When applying the business judgment rule, the courts do not protect decisions where the directors exercised little care in reaching the decision. This is an important but confusingly complex distinction.

In comparison to England and Delaware, Canada does not allow for a shift in the content of the directors' duty of loyalty which belongs only to the corporation and directors owe no duty to creditors when the company is insolvent or on the verge of it.[615] The content of directors' duties does not change when a company enters the so-called zone of insolvency or vicinity of insolvency. As mentioned in chapter 2, such terms convey no legal meaning according to the SCC. The court, however, agreed that it conveys deterioration in the corporation's financial stability. The directors in Canada as per the decision in *Peoples*

[615] However the later decisions in *BCE*, *supra* note 11 and *Festival Hall, supra* note 12 though not conflicting with *Peoples* have made the state of law confusing or rather unsettled.

owe a duty of care to creditors but it is not an independent duty and not applicable to directors of *OBCA* incorporated corporations. The decision of the court has been widely criticized by academics for extending the duty of care to creditors against the common law under which directors' duty of care is only owed to the corporation. That said, the Ontario Superior Court recently suggested that a duty of care could be extended to creditors under the common law but the case did not decide this issue.[616] There is no statutory statement of directors' duty to creditors in Canada and practitioners and academics usually rely on the SCC's judgment in *Peoples*. Incidentally, creditors could bring derivative and oppression actions but those remedies are restricted and the weakness of creditors' position is exacerbated further by the court's filtering out of their claims by narrow interpretations of the "complainant" definition. I have explained the inadequacies of these provisions below.

My analysis of legal remedies for creditors under Canadian corporate law and my review and comparison of the same with English and Delaware corporate law suggests that the Canadian remedies are inadequate to protect creditor interests. Under the Canadian law, directors remain in control of the insolvent corporation until a receiver/manager is appointed or there is either a petition or application under the *BIA*. In the period leading up to this shift, there is agreement in the literature of a considerable scope for wrongful conduct by directors.[617] Despite this knowledge, the legislature in Canada has done nothing to requisition directors to take immediate steps for the company to be placed in receivership, administration or liquidation if at any time they consider it to be insolvent. In contrast, the wrongful trading provisions in the *IA 1986* impose such a requirement exposing any director who is party to the company's continued trading to civil liability. There is no such corresponding provision in Canada and, based upon my research and analysis, I suggest that wrongful trading provisions or a similar version thereof be adopted in Canadian corporate statutes to redress the inadequacies of the present regime.

"Wrongful trading" is dealt with in s.214 of the *IA 1986*. The doctrine is very wide and

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[616] *Festival Hall, supra* note 12
[617] Sarra, *supra* note 44 at 35

catches all sorts of activity or inactivity which involves directors' misconduct and imposes a kind of retrospective obligation on the directors' of a company which in fact goes into insolvent liquidation to mitigate the loss occasioned to creditors.[618] This provision provides a kind of counter-incentive for the directors to give appropriate regard to the interests of the creditors in situations of risk mentioned above.[619] Paul L Davies calls it "the most important modern statutory exception to the principle of limited liability."[620] The section could be invoked only by the liquidator and requires the identification of a date on which the directors' knew or ought to have known that the insolvent liquidation was inevitable. From that date, directors who fail to take every step which ought to have been taken to minimize the loss to creditors could be ordered to contribute personally to the assets of the company. Section 214 provides its built in objective and subjective tests that are designed specially to protect creditor interests in insolvent or financially distressed corporations. I may remind that this test is the same as the test for the duty of care. In my view, it would be a wrong inference to draw that wrongful trading provisions could lead to risk aversion in directors. I have addressed this argument below but I may state again that according to my analysis the provision does not lead to risk aversion by directors. Instead it is aimed at encouraging responsible risk taking by directors. The provision is a model to achieve competence and excellence in corporate governance. Statutory interpretation by the English courts and scholarly literature on its merits and demerits are an invaluable guide to Canada in adopting a similar version of it. The scope and mechanics of the obligation would require in depth study and clear articulation by Canadian legislative bodies.

In an article by Jacob S. Ziegel written[621] in 1993 the learned author proposed the adoption of a restrained version of s.214 of the *IA 1986* to address the abuses of limited liability in the insolvency context. It has been two decades since that article but, sadly, Canadian creditor protection law still lacks coherence and waits much needed refinement to directors' duties to the creditors of an insolvent or financially distressed corporation.

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[618] Milman, *supra* note 333 at 229
[619] Gower, *supra* note 189 at 221
[620] Gower, *supra* note 189 at 237
[621] Ziegel, "Creditors Stakeholders", *supra* note 19 at 524

Interestingly, Prof. Ziegel in the same article strongly backed the oppression remedy's potential for creditor protection. The SCC also in the *Peoples* case heavily relied on oppression as a promising broad remedy for creditors while downplaying the need for more specialized mechanisms. I disagree both with Prof. Ziegel and the SCC. In my view, oppression never had any such potential otherwise in the past two decades we would have witnessed it. Besides, it may be kept in mind that oppression was never contemplated as a remedy for creditors by the Dickerson Committee which drafted the new *CBCA*. Its usual purpose, according to the Committee's Report, was to grant minority shareholders protection.[622] Creditors fall into the category of discretionary complainants under s.238(d) of the *CBCA*. A main hurdle for any potential discretionary complainant is to show that he suffered from the conduct concerned.[623] Creditors as such are not entitled to standing under the oppression remedy as of right but may be given standing to proceed as a discretionary complainant by the court.[624] According to VanDuzer, the courts in Canada have generally been reluctant when exercising their discretion to permit an oppression application made by a creditor despite the express reference of the remedy's availability to creditors in s.241(2) of the *CBCA*.[625] Thus, creditors are not routinely granted complainant standing on application to court for an order of oppression under s.241 of *CBCA*. This reluctance is best reflected in the following paragraph:

> "A creditor is not specifically defined as a "complainant" under the CBCA and therefore creditors generally are not "complainants" as of right. The court may use its discretion to grant or deny a creditor status as a complainant under s. 238(d). It does not seem to me that debt actions should be routinely turned into oppression actions. I do not think that the court's discretion should be used to

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[622] Dickerson Report, *supra* note 28 at para 484

[623] McGuinness, *supra* note 53 at 1271

[624] McGuinness, *supra* note 53 at 1272 para 13.76 (citing *Glasvan Great Dane Sales Inc. v Qureshi,* [2003] CarswellOnt 2420 at para 33 (WL Can)); also *Trillium Computer Resources Inc. v. Taiwan Connection Inc.,* 1992 CarswellOnt 690 at para 9 (WL Can) (The applicant commenced these proceedings by way of application seeking relief under the provisions of the *OBCA*. Counsel for the applicant asked the court to exercise its discretion under section 245(c) (same as s.238(d) of *CBCA*) to permit the application to proceed. He contended that his client came within the provisions of section 248 (same as s.241 of *CBCA*) as a complainant who was also a creditor of the respondent corporation. The court did not consider the applicant to be a proper person to make an application under Part XVII and the application could not proceed under section 248)

[625] VanDuzer, *supra* note 147 at 424

> give a "complainant" status to a creditor where the creditor's interest in the affairs of a corporation is too remote or where the complaints of a creditor have nothing to do with the circumstances giving rise to the debt or if the creditor is not proceeding in good faith. Status as a complainant should also be refused where the creditor is not in a position analogous to that of the minority shareholder and has no "particular legitimate interest in the manner in which the affairs of the company are managed."[626] [Citations omitted]

The above confirms how inherently wrong it is to assume oppression is a potential effective remedy for creditors. Rather than being a broad remedy, oppression serves as an impediment for creditors of corporations as its availability is limited at the outset by both who is a proper complainant and who could actually obtain a remedy. It is also limited by the court's determination of reasonable expectations. Regard may also be had to the fact that other common law jurisdictions such as England[627] provide for an oppression remedy but do not allow creditors to invoke it and the use of the remedy is limited to shareholders. In the United States too, while various corporate statutes contain some version of the oppression remedy, it does not extend to creditors. Canada and its provinces therefore stand virtually alone in this regard.[628] Thus, the scope of oppression as a remedy for creditors in my view is highly contested and doubtful. As I said in chapter 2[629] in *Sidaplex-Plastic* and *Downtown Eatery* creditors were given standing to bring oppression action but overall courts decisions are inconsistent about oppression and creditors. Some of the reasons for this lack of recognition by courts have been discussed above and in chapter 2.[630] Wrongful trading provisions may therefore give creditors more defined rights.

The creditors are entitled to bring a derivative action but only to enforce rights of the corporation. It is not available as a remedy to enforce rights of an individual creditor or even a group of creditors although a group of creditors may bring, in representative form, a derivative action if allowed in the name of the corporation provided the issue could be

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[626] *Royal Trust Corp. of Canada v Hordo,* 1993 CarswellOnt 147 para 14 (WL Can)
[627] For example s.994 of the *CA 2006* and s.459 of the *CA 1985*
[628] Brian Morgan and Harry Underwood, "Symposium on Officers' and Directors' Duties to Creditors of an Insolvent Corporation" (2003) 39 Can Bus L J 336 at 363
[629] See para 2.6 above
[630] See para 2.6 above

characterized as the enforcement of a right of the corporation.[631] In reality, however, this provision suffers shortcomings similar to the oppression action. Creditors have to convince a court that they are a proper person to make an application.[632] They have to establish that they are acting in good faith and the action is in the interests of the company.[633] Furthermore, creditors have to give 14 days notice to the directors that they intend to bring derivative proceedings.[634] The Canadian courts have further limited the right of creditors to proceed by requiring them to establish that they have either a direct financial interest in the affairs of the company or a particular legitimate interest in the way that the company is managed. Also, courts require creditors to demonstrate that their position is analogous to minority shareholders who have no legal right to influence the things that they regard as abuses of management. Furthermore, even if an order is obtained, it has to be enforced and there is a possibility that the directors may be impecunious rendering the proceedings possibly tantamount to useless.[635] This however may be a practical limitation for any personal action against directors including wrongful trading. Any recovery in a derivative action belongs to the corporation. This may be contrasted with the wrongful trading provision in England where a liquidator holds any award under the provision for distribution to unsecured creditors and is therefore not available for a charge holder.[636] However, the court has discretion to make any order any time it thinks fit including *inter alia* to direct that any amount adjudged payable by a defendant in an action be paid, in whole or in part, directly to former and present security holders of the corporation instead of to the corporation.[637] However, the said provision does not mention creditors and I have found no reference in the literature to any such order that has been made in favour of the creditors by the court. The court is also vested with the discretionary power to make orders concerning the reasonable legal fees of the

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[631] Dickerson Report, *supra* note 28 at para 481
[632] Section 238 of *CBCA*
[633] Section 239(2)(b)(c) of *CBCA*
[634] Section 239(2)(a) of the *CBCA*
[635] Keay & Dr Peter Walton, *Insolvency Law Corporate and Personal* (Jordans: 2008) at 616 [Keay & Walton]
[636] Keay & Doyle, *supra* note 635 at 236 (citing *Re Oasis Merchandising Services Ltd,* [1995] BCC 911, affirmed on appeal [1997] 1 All ER 1009, [1997] BCC 282)
[637] Section 240(c) of the *CBCA* (the section provides a list of four orders as illustration but the court's discretion to make orders is not limited)

action concerned.[638] This power extends to complainants in connection with the action and may apply to creditors as well.

The SCC rejected, in *Peoples*, the shifting of fiduciary duty in favour of creditors of insolvent or near insolvent companies. It is unclear how courts would interpret this statement and whether they would be willing to abandon their filtering out approach on a creditor's application for leave to bring a derivative action. In my view, a creditor's position is highly unlikely to change because the issue with the remedy is not mere application but causes rooted in the statute. It is structurally defective for creditors.

As to the duty of care, it may hardly be called a protection to creditors because the *OBCA* does not recognize any such duty to creditors and, under the *CBCA*, it does not provide an independent cause of action for creditors. The action for breach of the duty of care could accordingly be derivative. That said, the duty of care provision under s.122(1)(b) has inherent serious flaws as it does not deal specifically with wrongful trading. The standard of care under this provision is objective. Furthermore, the Canadian corporate law or its various insolvency regimes does not deal specifically with wrongful trading and there is no liability on directors who persist in trading even when a corporation is hopelessly insolvent.[639] Section 122 of the *CBCA* neither lays down a remedy for breach of the duty of care nor any particular mischief in respect of which the said duty will arise. The SCC in *Peoples* held that the liability for breach of the duty of care could be determined by civil action[640] in accordance with the principles governing the law of tort and extra contractual liability.[641] But this case was decided in accordance with the *Quebec Civil Code* and the court provided no analysis of the same under the common law. It is confusing because Canadian courts provide no guiding principles with regard to insolvent trading under the rubric of tort. Also, it is highly unlikely that corporate directors will be found liable without personal fault which is not a pre-requisite for wrongful trading but an essential requisite for liability in tort. Also, what constitutes "fault" is debatable. The

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[638] Section 240(d) of the the *CBCA*
[639] McGuinness, *supra* note 53 at para 13.190
[640] The case arose in Quebec and decided in accordance with its civil law
[641] *BCE*, *supra* note 11 at para 44

same is true for breach of contract as directors will not be found liable failing fraud or misrepresentation or unless there is a separate duty arising.[642] Needless to say that presumptive possibility of liability in tort or its ilk is no substitute for a wrongful trading type of doctrine. An advantage of wrongful trading provisions is that they have their own built in standard to determine loss which corresponds to the statutory duty of care. This helps establish causation. The standard for the statutory duty of care in England is similar to Canada and so wrongful trading provisions could easily work here. The SCC extended the duty of care to creditors in *Peoples* but the situation is not clear as to how it will be enforced considering, at common law, directors owe their duties to the corporation alone. A wrongful trading sort of doctrine could resolve the inconsistency. It is same as the duty of care but is indirect as it is enforced through a liquidator.[643]

I discussed both the Canadian and Delaware business judgment rule in chapter 4. It is a complex rule that originated in American jurisprudence. The purpose of this rule is to protect directors' honest and prudent risk taking but, arguably, it simply encourages directors to take risks.[644] According to ALI's Principles, the rule protects "directors from the risks inherent in hindsight reviews of their unsuccessful decisions".[645] The rule definitely is in its developmental phase in Canada and its application is not very clear. In *Peoples,* the SCC invoked the business judgment rule in absolving directors from liability as it found the implementation of the new procurement policy to be a reasonable business decision. The SCC did not inquire as to how reasonably informed the directors were. In my view, the SCC failed to appreciate that the directors breached their duty of care and good faith. In *Peoples* the directors failed *inter alia* in fulfilling their duty of due care by not taking into consideration the consequences of the implementation of the new inventory policy, the special circumstances of the companies, and by failing to consult their legal advisor before implementing that policy.[646] In Delaware, when applying the business judgment rule, the courts do not protect decisions where little care is exercised in reaching the decision. It is important that we have proper legal mechanisms to protect

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[642] Sarra, *supra* note 44 at 37
[643] See chapter 3 part II for complete discussion on it
[644] Bainbridge, *supra* note 501 at 105
[645] Bainbridge *supra* note 501 at 105 (citing ALI Principle 4.01cmt.d at 141)
[646] *Peoples QCA, supra* note 10 at para 45

creditors because our business judgment rule is not as developed as the American version and, by applying it without understanding it completely, we would be rewarding directors for putting creditors' interests at stake.

In Greenberg J.'s judgment in *Peoples,* the following paragraph is noteworthy to consider:

> "Directors are also held to a duty of care. They must meet this standard with conscientious fairness. For example where their methodologies and procedures are . . . so shallow in execution . . . or half heated as to constitute a pretext or a sham, then enquiring into their acts is not shielded by the business judgment rule. The law is settled that the duty of due care requires that a director's decision be made on the basis of reasonable diligence in gathering and considering material information. In short a director's decision must be an informed one."[647] [This was quoted during trial from a Canadian book discussing a US case law]

I agree with the analysis of Greenberg J. in *Peoples*. In my examination, the SCC failed to appreciate this important distinction. The SCC missed the whole point that the directors were grossly negligent and breached their duty of due care (Delaware jurisprudence is clear on this). The directors did not specifically apply their judgment on the credit worthiness or lack thereof of Wise Inc. or what the financial consequences would be for Peoples Inc.[648] In Delaware, in order to invoke the business judgment rule, certain pre-conditions have to be established but, in *Peoples,* no such discussion took place.[649] Could it be because Canada has not imported the business judgment rule in its entirety? Or could it be because, in this case, interested parties were creditors and not shareholders? To me, this is the same judicial non-recognition kind of approach that is reflective in Canadian case law on creditor oppression and derivative actions. It is inappropriate that Canada has a business judgment rule but no substantive review is done. In the meantime creditors could suffer and so there is a need to protect their interests by a legal mechanism such as wrongful trading.

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[647] *Peoples Superior Court, supra* note 10 at para 149 (citations and references omitted)
[648] *Peoples Superior Court, supra* note 10 at para 63
[649] In *Peoples* the directors were not disinterested or independent. *Peoples QCA, supra* note 10 at para 116 (it is stated " . . . the brothers, Wise and Peoples Inc. were related persons")

I would also like to point out that in an Ontario case involving the business judgment rule, it was held that:

> "Directors' are only protected to the extent that their actions actually evidence their business judgment. The principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions. Courts are entitled to consider the content of their decision and the extent of the information on which it was based and to measure this against the facts, as they existed at the time the impugned decision was made. Although Board decisions are not subject to microscopic examination with the perfect vision of hindsight, they are subject to examination."[650]

The court further provided that "the business judgment rule cannot apply where the Board of Directors acts on the advice of a director's committee that makes an uninformed recommendation. Although it was not unreasonable for the Board to assume the Committee had done a careful job, this did not relieve the directors of their independent obligation to make an informed decision on a reasonable basis."[651] In light of the above quotations, it is clear that in *Peoples* the business judgment review by the SCC is not rigorous. The SCC only states "after considering all the evidence we agree with the court of appeal . . ."[652] without going into the details of the evidence considered. It is unclear how the good faith was determined considering s.123(4)(b) *CBCA* and the defence of relying on an expert's report was also rejected. The directors were required to understand the terms and meaning of the policy and to consider it carefully and objectively against the circumstances of Peoples Inc. at the time. The adoption of a crucial policy at such a crucial time was considered ordinary business and given cursory consideration by the directors.[653] In *Peoples,* the directors in my view took a risky decision which they should not have taken considering the circumstances. This case highlights the great role our courts play in defining the functions of the board but above all it suggests that more protection is needed for creditors so that they are not the victims when the business judgment rule is applied.

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[650] *UPM, supra* note 54 at para 153
[651] *UPM,, supra* note 54 at para 155
[652] *Peoples SCC, supra* note 10 at para 68
[653] *Peoples Superior Court, supra* note 10 at para 56 and 57

Peoples, in my view, was a clear case of wrongful trading by incompetent directors who did not administer the accounts of parent and subsidiary companies properly and who knew from the very beginning of acquiring Peoples Inc. that their finances were tight. The evidence produced in the case clearly showed that the companies were struggling financially (e.g., Peoples Inc. prior to its acquisition by Wise Inc., was loss making to the extent of $10 million per year or that the purchaser Wise Inc. was having liquidity and capital squeeze to the extent that it had to take a bank loan[654] to arrange the initial purchase amount of Peoples Inc.,[655] or that the sale figures of the two corporations were constantly on the decline). I understand genuine financial needs of businesses. I am not arguing against loan taking or financing of businesses. Instead I am trying to highlight the policy issues that cases like *Peoples* highlight. The business practices of the Wise brothers are rather peculiar which the trial judge acknowledged: "At the time of the acquisition of Peoples, in addition to the T.D., Wise Stores had traditionally used its suppliers as a secondary source of financing. They would stretch their payables up to and even well beyond the limit. When they acquired Peoples, that same policy was carried forward for that company as well."[656] It is conduct like this that emphasizes the need for more protection for creditors from a policy perspective. The importance of wrongful trading outweighs any entrepreneurial risk taking. These are strong facts that go against Wise brothers continued trading, ignoring the financial implications to the creditors of Peoples Inc. The adoption of the joint inventory procurement policy as routine business practice with a blind eye is crucial evidence against the directors for wrongful trading.[657] Instead, we note that directors were exonerated in *Peoples* with no personal liability to creditors for the way they acted. No doubt the court was not able to find them liable because the provision and criteria it employed to judge them was not right for the wrongs committed. Pelletier J. A. of the Appeal Court specifically said: "the good faith apparent

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[654] See FN 390. My concern here is not upon the taking of the bank loan. Instead I agree with Warren Grover that SCC did not carry out a sophisticated analysis of the unique facts of this case.

[655] Cork Report, *supra* note 6 states at para 1785 that trading when a business is heavily under capitalized falls within "wrongful trading".

[656] *Peoples Superior Court, supra* note 10 at para 81

[657] Cork Report, *supra* note 6 states at para 1788 that a director will be personally liable if he actually knows that the company is trading while insolvent or unable to pay its debts as they fall due and has no reasonable prospect of paying them. Actual knowledge includes willful blindness. A person who resolutely shuts his eyes to the obvious or who deliberately refrains from asking obvious questions will be regarded as having actual knowledge.

in the transaction impugned is of great importance in the ruling."[658] With respect, that ruling is short sighted. It did not acknowledge the peculiar facts of the case. Of course, the courts could not refer to it if there is no wrongful trading provision in the *CBCA*. It may be kept in mind that wrongful trading is not about culpability or good faith. It is about causing loss to creditors knowingly[659] when the corporation is insolvent or near it. The provision does not impose any criminal liability so culpability or blame[660] does not play a role. The objective and subjective tests under the provision are to determine knowledge. I may explain this by applying *Peoples* facts to the wrongful trading provisions as in England so that it is easy to understand my argument:

(i) Is the company in insolvent liquidation? {Yes, Peoples Inc. was in insolvent liquidation} (s.214)(2)(a))

(ii) During some time before the commencement of the winding up of the company did the directors know or ought to have concluded that there was no reasonable prospect of the company avoiding an insolvent liquidation? {Again yes. There was ample evidence but directors turned a blind eye to the financial distress of the companies. As mentioned prior to Peoples Inc.'s acquisition by Wise Inc., it was loss making to the extent of $10 million per year.[661] The purchaser Wise Inc. was under capitalized.[662] The sale figures of the two corporations were constantly on the decline.[663] In fact around the end of January 1994, Peoples Inc.'s sales volumes fell some $32 million below forecasts.[664] Peoples Inc. continued to operate at a loss as the profits were completely artificial.[665] These facts *inter alia* ought to have informed any

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[658] *Peoples QCA, supra* note 10 at 61

[659] The essential element to prove wrongful trading is actual or deemed knowledge not subjective culpability or wrongdoing.

[660] Though in *Continental Assurance* the judge focused on conscientiousness of directors. Andrew Keay thinks that such reasoning has diminished the effect of s.214 as blameworthiness should only be relevant in determining the level of contribution to be paid by a director who is found liable.

[661] It was a leveraged buy out under which Peoples Inc. amalgamated with Wise Inc. as its subsidiary on January 31, 1993

[662] Cork Report, *supra* note 6 states at para 1785 that trading when a business is heavily under capitalized falls within "wrongful trading".

[663] *Peoples QCA, supra* note 10 at para 147

[664] *Peoples QCA, supra* note 10 at para 31

[665] *Peoples QCA, supra* note 10 at para 147

prudent director that the company is in financial distress. Wrongful trading is based on the state of knowledge of directors at the relevant date. The court applies that knowledge to the facts of the case to determine whether directors knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation. Wise brothers became Peoples Inc.'s directors around January 1993 when Peoples Inc. became a wholly owned subsidiary of Wise Inc.[666] In June 1994, the financial results of the group showed that Wise inc. was $18,664,000 in debt to Peoples Inc. (though it was regarded inflated due to an accounting error).[667] For September, October and November 1994, the financial results were again disappointing. They forecast that Peoples Inc. would sustain a $7,104,000 loss in sales volume and Wise a $4 million loss. Sixty percent of the group's operational losses were attributable to Peoples Inc., and 40% to Wise.[668] According to the trial judge the debt Wise Inc. owned Peoples Inc., at the time of bankruptcies (since the joint inventory procurement policy was implemented in February 1994) amounted to $4,437,115. All these facts show that at some point in all these factual happenings directors should have known or concluded that the company had no reasonable prospect of avoiding insolvent liquidation. The provision however requires that it be proved that the directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid an insolvent liquidation which the court does on the basis of all the available evidence} (s.214(2)(b)).

(iii) Following the time that directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation did they take every step to minimize the potential loss to the company's creditors as they ought to have taken? {No, *Peoples* facts show that directors failed in this test. They instead adopted a new inventory procurement policy under which People Inc. was responsible to purchase all the North American merchandise for Wise Inc. The policy was adopted in

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[666] *Peoples SCC, supra* note 10 at para 12
[667] *Peoples QCA, supra* note 10 at 33
[668] *Peoples QCA, supra* note 10 at 37

February 1994, as routine business practice without any due diligence or seeking any expert legal or professional advice regarding its feasibility for Peoples Inc. Once adopted directors never monitored the amount of debt resulting from Peoples Inc.'s assumption of most of the cost of Wise Inc.'s purchases under the said policy. The policy was accepted by just cursory consideration informally by brief consultations among the Wise brothers, with no formal resolution enacted by the board of directors. The People Inc.'s minute book was silent to this whole concept.[669] According to the trial judge's analysis and I agree with him, this policy had disastrous financial consequences for Peoples Inc. It was used to subsidize and support Wise Inc. as it had a deficit and was fully extended towards the bank whereas Peoples Inc. had earnings. A reasonable prudent and diligent person would have concluded that the new inventory procurement policy would strip away assets from Peoples Inc. and that Peoples Inc. would have an account receivable from Wise Inc. that would likely not be collected or be uncollectible as Wise Inc. had cash flow problems and was under-capitalized.[670] All the steps directors took to implement the said policy were against creditors' interests e.g., Peoples Inc. was solely responsible to pay suppliers for Wise Inc.'s merchandise, there was no written agreement evidencing the terms of this arrangement and no security requested or taken by Peoples Inc. from Wise Inc. for this arrangement.[671] Both the trial and appellate judgments are fact intensive and sufficiently prove wrongful trading. There was no room for alternate interpretations to exonerate directors on grounds of good faith, culpability or business judgment. The only requirement for wrongful trading is factual knowledge and *Peoples* fulfills all those requirements} (s.214(3)).

(iv) The courts employ an objective and subjective test under which the ***"facts"*** which a director ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained or reached or taken by a reasonably diligent person having (a)

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[669] *Peoples Superior Court, supra* note 10 at para 56
[670] *Peoples Superior Court, supra* note 10 at para 58 & 64
[671] *Peoples Superior Court, supra* note 10 at para 65

the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as carried out by that director in relation to the company (objective element) (b) the general knowledge, skill and experience that that director has (subjective element) {Wise brothers before acquisition of Peoples Inc. were directors of Wise Inc., which consisted of a chain of stores founded in 1930 by their father. The eldest brother came into business in 1952 and the other two in 1957 and 1964 respectively. The chain had grown to 50 stores by 1990. Upon acquisition of Peoples Inc. the brothers became its directors as well. The facts under which the said policy was adopted and continued prove that the Wise brothers failed the test of a reasonably diligent person. Wise brothers were shrewd businessmen. They had an intimate knowledge of the business and ought to have known the financial mess in which both companies were. Any reasonably diligent person in comparable circumstances would have concluded that the adoption of the said policy at such crucial time would be suicidal for the company. Section 214(4) includes a reference not only to facts that a director ought to know but also to facts that he ought to ascertain. People Inc.'s balance sheet as at April 30, 1994 clearly confirmed that Wise Inc. owed more than $18 million to Peoples Inc.[672] This is a huge sum considering Wise Inc. was already in a financial crunch. It confirms that the Wise brothers unduly favoured Wise Inc. to the detriment of Peoples Inc. and its creditors when it was financially depressed. The debt resulting from the negligent adoption of the policy when there was financial distress led to the demise of Peoples Inc. The directors did not take "every step" to minimize further loss to creditors of People Inc., as required by the wrongful trading provisions which ultimately led to filing of bankruptcy on December 1994 by M&S. The continued wrongful trading of the company may have worsened Peoples Inc.'s position. All these facts prove wrongful trading} (s.214(4)) (emphasis to "facts" added).

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[672] *Peoples Superior Court, supra* note 10 at para 74

It is stated in the *Peoples* case that the proceeds from the liquidation of both companies assets were sufficient to pay secured claimants such as TD Bank, M&S and the landlord's leases. The only unsatisfied claimants were trade creditors. It is not clear how much in total was owed to these unsecured creditors and if they were paid fully after realization of the People's estate. It is, however, clear that these claims were in bulk with $21,471,865.00 owing to merchant suppliers alone.[673] Greenberg J. calculated the net amount of damages to unsecured creditors in the sum of $4,437,115.00 so it could be assumed that the total claims were roughly around this figure.[674] These creditors stand to lose a lot and wrongful trading would help them with recovery.

Other misconduct of the directors in *Peoples* that could easily be considered wrongful trading include not reducing terms of the joint inventory procurement policy into writing,[675] not providing in the arrangement for how soon Wise Inc. was required to repay Peoples Inc. for Wise Inc.'s share of the inventory,[676] not providing for whether Peoples Inc. could charge interest or be compensated for its services as the inventory procurer.[677] These acts reflect on the incompetence of directors. Any prudent person realizing the financial distress would take all precautionary measures to avert unforeseen risks. The most important lapse of the directors was that they never took any security from Wise Inc. for this arrangement[678] and did not designate any one to monitor or control the indebtedness of Wise Inc. to Peoples Inc.[679] A prudent director would have taken all these steps knowing the fragile financial state of the companies. Sadly, there is no statutory duty in Canada yet on directors' to act responsibly when insolvency is imminent. All these facts demonstrate the need for a wrongful trading sort of provision to protect creditors interests and which, if violated, would entail personal liability for directors.

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673 *Peoples Superior Court, supra* note 10 at para 401
674 *Peoples Superior Court, supra* note 10 at para 430
675 *Peoples Superior Court, supra* note 10 at para 65
676 *Peoples Superior Court, supra* note 10 at para 65
677 Jacob S Ziegel, "Corporate Governance and Directors' Duties to Creditors: Two Contrasting Philosophies (2003) Annual Review of Insolvency Law 132 at 136 [Ziegel "Corporate Governance"]
678 *Peoples Superior Court, supra* note 10 at para 65
679 *Peoples Superior Court, supra* note 10 at para 65

In *Peoples,* the impugned conduct consisted of Peoples Inc.'s directors entering into an allegedly disastrous inventory procurement policy with its parent corporation Wise Inc. The Wise brothers were directors of both Peoples Inc. and Wise Inc. They were also majority shareholders of Wise Inc., which held all the issued and outstanding shares of Peoples Inc. The Wise brothers may have derived no direct personal benefit as directors from the new procurement policy but, as controlling shareholders of Wise Inc., they benefited indirectly from the credit extended by Peoples Inc. The effect of entering a highly unfavourable contract is the same as a gratuitous transfer of property by an insolvent corporation or transfer at undervalue which arguably made the Wise brothers party in the transaction and liable for wrongful trading.

Thus, a wrongful trading kind of mechanism will have a positive effect in regulating the above noted and/or other excessive risky behavior by Canadian directors. But critics argue that creditors negotiate agreements freely and ensure compensation for risks associated with the transaction so is it fair to seek further protection by law for them if they themselves fail to protect their interests by contract? My first response to this question would be that this could be answered by empirical evidence only. Secondly, I would argue that risk assessment is a problematic issue. Not all contingencies are apparent to the human mind and not everyone is a sophisticated creditor to be able to understand the intricacies of contracts. It may be true that creditors bargain the terms of contracts, which as Prof. Telfer said involves risk[680] but the said risk attaches to "business" and not negligent or wrongful conduct by managers of business which is ignored under Canadian law. Also what about unsecured creditors such as trade creditors who do not even bargain for their protection? We should be mindful not only on whom the costs of the firm's failure ultimately fall but also who is disproportionately affected. If we analyze on this basis, there is no doubt creditors and in particular unsecured creditors are not sufficiently protected. Canada does not have negligence-based directors wrongful trading provisions either in its corporate statute or bankruptcy statue. In light of the developments in other jurisdictions, a review of our current corporate law is definitely worthwhile.

[680] Ross Grantham, *supra* note 5 at 130

Critics may also attack my proposal on the ground that making more law could have a negative effect on the directors' risk taking role but we need to be mindful of the fact that insolvency is a serious situation where risk taking needs to be responsible. Excessive risk taking could be harmful. Legislation will make directors sensitive to such complexities in respect of financially distressed and insolvent corporations. Effective governance could deter corporate misdoings and avoid much resultant social and economic harm and evils. Some scholars have argued in the literature that raising the standard of conduct for directors could deter people from accepting directorships.[681] But I argue that there is no demonstrative evidence of the same. Indeed, in *Continental Assurance plc.,* Park J. was concerned that judging non-executive directors in a wrongful trading case might send a wrong signal to directors refraining them from taking up such positions. The fact of the matter is that directors were not found liable.

Prof. Telfer, in a trenchant attack on the New Zealand equivalent of s.214, argues that liability on directors would impose costs and undermine the wealth creating capacity of the company.[682] I would argue that condoning irresponsibility and wrongfulness is not only costly but has systemic implications. In my view, the importance of deterring wrongful trading outweighs the need for any entrepreneurial risk taking. I may add for critics console that s.214(3) itself provide directors a defence that only requires from them reasonable knowledge that the company would not be able to avoid going into insolvent liquidation which is not at all stringent to meet. They also have the defence of good faith reliance under s.123(4) of *CBCA* and s.135(4) of *OBCA*. Needless to mention, England and other common law jurisdictions have specifically incorporated defences to relieve directors from liability.[683] The proposal for "anticipatory declaration" mentioned in the Cork Committee's Report is also worth considering under which a director may apply to court in advance for relief if concerned that he is or may be found party to wrongful trading.[684]

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[681] Ross Grantham, *supra* note 5 at 137
[682] Ross Grantham, *supra* note 5 at 135
[683] Section 1175 of the *CA 2006* discussed at length under para 3.9 above
[684] Cork Report, *supra* note 6 para 1798

Economists allege that directors who are placed under pressure resort to defensive measures and become risk averse[685] which hampers the growth of the company and so efficiency is not fostered and instead monitoring requirements are increased. However, an obligation to creditors does not limit directors from risk taking but instead aims to achieve responsible risk taking. As to the increased costs arising from monitoring, my answer is that directors are responsible for the supervision of the company and so nothing new is added to their role that was not already there. It would in fact lead to improved company procedures and practices which could, in turn, lower costs and increase profits thereby promoting overall efficiency. Also, what enhances value could never be unfair or inefficient. In my view, both an obligation to creditors and responsible risk taking could co-exist and that's what wrongful trading provisions achieve. They bring coherence and clarity. It may also be kept in mind that law and economic theory does not represent the position of closely held corporations. Scholars argue that the law and economics theory instead focuses on large listed public companies, banks and other institutional lenders.[686]

With regard to s.214 of the *IA 1986* it is creditors in closely held companies that are at most risk as it is mostly the directors of closely held companies that have been involved in legal proceedings under s.214 jurisprudence. An empirical study in Australia also confirms this result with regard to their wrongful trading provision.[687] The study found that directors of private companies were involved in 91% of cases brought against the company.[688] Directors were major equity holders in those companies which explains their eagerness to seek out every risk to save their company.[689] In Canada, the number of closely held corporations is much higher than public companies.[690] In fact, creditors in

[685] Frank H Easterbrook & Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991) at 99-100 read with Keay, *Responsibilities to Creditors*, *supra* note 85 at 310
[686] Keay, *Responsibilities to Creditors, supra* note 85 at 319
[687] Keay, *Responsibilities to Creditors, supra* note 85 at 354 (citing James P, Ramsay, I M and Siva P, "Insolvent Trading - an empirical study" (2004) 12 Insolvency Law Journal 210 and an earlier draft is available on the website of the Centre for Corporate Law and Securities Regulation, University of Melbourne <www.cclsr.law> http://cclsr.law.unimelb.edu.au/research-papers/Monograph%20Series/Insolvent%20Trading%20final.pdf)
[688] Keay, *Responsibilities to Creditors, supra* note 85 at 354
[689] Keay, *Responsibilities to Creditors, supra* note 85 at 354
[690] The number of public companies is approximately 3572 according to research run for "all public" companies in Canada on LexisNexis academic <http://www.lexisnexis.com/hottopics/lnacademic/?> on July 20, 2012. In comparison, the number of private companies is approximately 1,048,900 according to

Canadian closely held corporations are more at risk than other countries as it is relatively easy to incorporate a closely held corporation under Canadian corporate law with no counter balancing duties on directors to creditors. Incorporation of closely held corporations is easy in US and England as well but England has neutralized its consequences for creditors if the business fails by incorporating wrongful trading, fraudulent trading and *CDDA 1986* type of provisions and in US the business judgment rule arguably serves as a double-edged sword to protect against breach of duty by directors as "arguably *Cede*[691] has broadened the scope of judicial review of board decision-making to reach not just the process by which the decision was made but also the substance of the directors' decision".[692] In Canada for closely held corporations there is no minimum requirement for paid up capital, no need to publish company accounts, shareholders loans could be taken out to meet the company's operational needs without placing sufficient capital at incorporation and shareholder loans could be drawn on the company's assets making unsecured creditors claims low in priority.[693] All these rules arguably could have repercussions for creditors in an insolvent or financially distressed company. For example, requirements on minimum capital are commonly imposed in Continental European systems but are non-existent in United States or common-wealth countries[694] such as in England,[695] Australia or Singapore.[696] In Germany, the minimum capital required for incorporating a private limited company (GmbH) is €25,000 and an

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2009 Statistics Canada's Data for Employer Businesses in the Private Sector (CANSIM table 527-001) (In reality it may be much higher than this figure because a lot of small company owners don't even employ anyone). The said Data include both incorporated and unincorporated businesses that issue one or more T4 slips to their employees, available on Statistics Canada web-site: <http://www5.statcan.gc.ca/cansim/pick-choisir?lang=eng&p2=33&id=5270001>; also Nicholls, *Corporate Law, supra* note 124 at 121 (stating "private, closely held corporations are the norm in Canada. Large, publicly traded corporations are very much the exception"). Incidentally, according to the most recent figures from UK Companies House records there are 2,588,856 companies registered in the United Kingdom, of which only 10,412 are public companies. See
http://www.companieshouse.gov.uk/about/busRegArchive/business_register_statistics_november_2009.pdf (citing from UK Palmers Company Law, vol 1, Part 2, Chapter 2.1 (Sweet & Maxwell, 2012) at para 2.101 available at WL UK)

[691] *Cede, supra* note 484

[692] Bainbridge, *supra* note 501 at 102; also see para 4.2

[693] Ziegel "Corporate Governance", *supra* note 677 at 156

[694] Gower, *supra* note 189 at 261, FN 19

[695] Gower, *supra* note 189 at 261

[696] International Encyclopedia of Comparative Law, vol 1, Ch. 2 (New York, Oceana: Tübingen: J.C.B. Mohr (Paul Siebeck)) "Business and Private Organizations" at 2-14 [International Encyclopedia]

Austrian GesmbH needs €35,000 as initial minimum capital.[697] The substance of my argument, however, is not these ceilings or to discuss the merits of having minimum capital rules. Instead, I am trying to make a policy argument to seek more protection for creditors to whom such rules pose uncompensated risks. It is a serious issue and, at one time, Belgium agreed to make the founders of an LLC liable to creditors if the company failed within three years of its creation.[698] Thus, this is a menace and countries have adopted different legal measures to tackle it. This may be one reason that the UK, New Zealand, Australia and Singapore have wrongful trading provisions. This provision counter balances the exposure of creditor risks. The solution to protect creditors is, therefore, to have a carefully drafted wrongful trading provision which would arguably force directors to take corrective action and a mechanism to which creditors could look upon if the company fails. Davies has put it succinctly:

> "The wrongful trading and disqualification provisions may be said to make feasible in public policy terms the adoption by companies of what might be thought to be, from the creditors' perspective, risky financial structures. Those risks are moderated by the imposition of a legal duty on the directors towards the creditors and the threat of future exclusion from use of the corporate form. Ex post control is less of a drag on enterprise than minimum capital rules but ex post controls require more enforcement effort than conditions applicable to the formation of the company."[699]

It is understandable that businesses need to grow but if the business does not prosper, creditor interests would be threatened. Canada could, like England, functionally substitute the lack of minimum capital rules at least for private companies by providing wrongful trading and disqualification provisions.[700]

I would like to point out that the wrongful trading mechanism to protect the interests of creditors would fulfill competing public policy concerns. Firstly, wrongful trading provisions are efficiency enhancing. Andrew Keay argues that limited liability without

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[697] Marco Becht, Colin Mayer & Hannes F Wagner, "Where do firms incorporate? Deregulation and the cost of entry" Law Working Paper no 70/2006 (August 2007) at 31 (available at Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=906066>)
[698] International Encyclopedia, *supra* note 696 Ch. 2, at 2-64
[699] Davies, *supra* note 4 at 95
[700] Davies, *supra* note 4 at 94

the counter balancing of a directors' duty to creditors is inefficient as shareholders are able to "effect uncompensated transfers of business risks to creditors thus creating incentives for excessive (inefficient) allocations of social resources to risky economic activities."[701] It may be asked why couldn't creditors restrict such transfers contractually? The answer is that they may be able to do so by invoking the contractually specified events of default to replace the existing board provided there is still a chance that company could be saved out of its difficulties.[702] However, it is highly unlikely that creditors could execute such provision for the reasons discussed in chapter 1. It is also debatable as to how many creditors are able to convince directors to enter this kind of arrangement and if entered are cognizant enough of the on-going financial position of the borrower company to realize the financial distress if any, in order to timely invoke it or take measures to crystallize their security (if secured). It may also be kept in mind that relying on creditors to take self-help measures could instead of solving any problem result in more problems because then we will be facing opportunism on the part of secured versus the unsecured creditors.[703] This issue has been recognized by the legislature and that is why certain unsecured creditors are given protection e.g., employees' claims to unpaid wages up to maximum $2,000 is secured and preferred under the provisions of the *BIA*; pension and certain other claimants also enjoy protections under the *BIA*.[704] Thus, relying on contractual arrangements may not be effective in each and every case. A directors' duty to creditors could do a better job.

Secondly, a corollary benefit of such provisions is that it will reduce the costs for creditors of due diligence when entering into loan arrangements. The duty would reduce both the costs of inquiring about and assessing the company's position *ex ante* and monitoring costs incurred by creditors *ex post*. It would also reduce the costs of lengthy and complex contracts and cumbersome covenants.[705]

A third benefit is drawn from England where a duty to consider creditor interests under

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[701] Keay, *Responsibilities to Creditors, supra* note 85 at 317
[702] Davies, *supra* note 4 at 69
[703] Davies, *supra* note 4 at 68
[704] Sarra, *supra* note 44 at 133 &122
[705] Keay, *Responsibilities to Creditors, supra* note 85 at 317

s.214 has both a private law and public law function. In the private function, it compensates creditors who suffer loss because of the liquidation of the company while the public function is linked to two important aspects. One, it prescribes a minimum standard of conduct of directors which indirectly benefits creditors and the general public alike because there are fewer corporate failures, job losses and other consequences.[706] Secondly, it is linked to the disqualification of directors who are found guilty of wrongful, fraudulent or unfit conduct.[707] In this sense, it plays a vital public function even though it is not a criminal provision by directly shielding both creditors and the public at large from incompetent directors.[708] I found its public function particularly interesting. Needless to say, the provisions would serve the same function for Canada.

The fourth benefit of a wrongful trading mechanism is that it would serve as a deterrent against director misconduct. It would discourage directors from committing excessive risk taking and thereby reduce social costs in three ways. First, it would forebear risky behavior to revive the company failing which creditors, employees, consumers, suppliers, pensioners, governments and shareholders are left to suffer.[709] Second, it would deter non-executive directors from passively acquiescing to risky actions proposed by other directors and, thus, make them proactive and diligent in their monitoring role.[710] Third, a potential liability might serve as the necessary counter balance to the pressure of shareholders on directors to indulge in risk taking.[711]

Fifthly, it would help both directors and the courts in steering a course through conflicting interests when the corporation approaches insolvency. Inconsistent application of public policies by the courts could cause uncertainty on the part of directors. This could lead to overly cautious conduct by directors in some cases and reckless conduct in others, not knowing what their exact legal obligations are when a

[706] See chapter 3 part II in general
[707] Section 6 and 10 of *CDDA 1986;* see para 3.11 above
[708] Keay, *Responsibilities to Creditors, supra* note 85 at 109
[709] Keay, *Responsibilities to Creditors, supra* note 85 at 318
[710] Keay, *Responsibilities to Creditors, supra* note 85 at 318
[711] Keay, *Responsibilities to Creditors, supra* note 85 at 318

corporation is financially distressed or insolvent.[712] A legal provision would help remove all ambiguities to directors' role and responsibilities.

The sixth benefit is directed at unsecured creditors[713] who disproportionally bear the costs when insolvency hits. It is unfair to the unsecured creditors of failed companies not to be adequately compensated for the gamble they have run. Needless to say, most institutional lenders seek security before extending credit and often companies have already charged up all or substantially all of their assets with these institutional investors leaving small creditors with no choice but to give credit without any security. There are several other reasons that these creditors fail to protect themselves including ignorance of the ramifications of dealing with a company, concern that a competitor might be able to provide the supplies or the funds if a decision to supply or lend is not made speedily or a threat that the company will move its business else-where.

Seventh, it would conclusively end the debate that has kept academics, jurists and scholars puzzled for decades with respect to the content of directors' fiduciary duties and help align the corporate objective. It will have a powerful effect on the future course of corporate governance in Canada and will bring much needed clarification to issues that are unclear such as insolvency, tests of insolvency, duty of care and application of the business judgment rule.

The eighth benefit is exclusively for directors of closely held corporations (who make up the vast majority of the total population of Canadian company directors). For these directors, often there is no regular access to legal advice (*Peoples* is an example). A duty to creditors would put the onus on directors to act responsibly in accordance with the legal requirements in or around insolvency. Ignorance of law is no excuse and a legal provision would put directors on notice of their duties to creditors.

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[712] Sarra, *supra* note 44 at 36

[713] Cork Report, *supra* note 6 states at para 233 that the principle of *pari passu* distribution has been left as a theoretical doctrine only as in a great number of cases assets of insolvent corporation are distributed among the preferential creditors (chiefly the revenue departments) and the holders of floating charges (often the banks) with little if anything for the ordinary unsecured creditors.

Ninth, wrongful trading provisions would encourage directors to satisfy themselves that their companies are adequately capitalized with regard to the scale of their operations and the level of their proposed commitments. It would balance the lack of a statutory minimum paid up capital requirement for closely held corporations in Canadian corporate statutes. There is no empirical evidence that the provisions are inefficient, value destroying or cause over capitalization by increased risk aversion.

Lastly, it has been recognized in the literature that wrongful trading provisions might cause creditors on some occasions to refrain from initiating liquidation proceedings against the company as it could assure them that if directors take any improper action of failing to consider their interests during this period, they would expose themselves for breach of duty. This would be beneficial for everyone involved with the company in one way or another such as shareholders, salaried employees, consumers, creditors, suppliers, pensioners, accountants and the governments and thus, promote a rescue culture.[714]

To sum up, this paper has analyzed directors' duties to creditors at length. It is my suggestion that Canada should consider wrongful trading provisions as, at present, my research and analysis shows creditors in Canada have inadequate protection compared to other jurisdictions. This paper suggests that s.214 of the *IA 1986* could provide a useful model to Canadian legislators to draft a provision on those lines. It would be self-repetition but such a doctrine in the statue book is a must have not only due to public policy reasons but also to keep up with international standards as well as to give our laws a coherent, efficient and precise look.

An American jurist Justice Holmes once said that he thought of the law as a "bad man" would: what sanctions may be applied to contemplated conduct and what is the probability of its being applied.[715] With respect, such abstract notions of "law" do not fit in this day and age. In reality, human conduct needs regulation and directors are no exception. Duties and obligations have to be clear and precisely laid down for corporate

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[714] Keay, *Responsibilities to Creditors, supra* note 85 at 318
[715] Hopt, *supra* note 48 at 329

managers to have sufficient guidance. Needless to say, the current global state of economic recession heightens concern for creditors' protection. Wrongful trading provisions in the corporate statute could create a positive effect in protecting creditors.

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