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A Director's Duty to Act in the Best Interests of the Corporation in an Insolvency or "Vicinity of Insolvency" Situation: The Case for a Return to Basic Economic Principles

(Spine title: A Director's Duty)

(Thesis format: Monograph)

by

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Graduate Program in Law

2

A thesis submitted in partial fulfillment
of the requirements for the degree of
Masters of Law

School of Graduate and Postdoctoral Studies
The University of Western Ontario
London, Ontario, Canada

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THE UNIVERSITY OF WESTERN ONTARIO
SCHOOL OF GRADUATE AND POSTDOCTORAL STUDIES

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Date: ______________________

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Chair of the Thesis Examination Board

ABSTRACT and KEYWORDS

This thesis examines the competing principles within the decision-making models for what it means for directors and officers to act in the best interests of the corporation. The first model is the traditional shareholder primacy model, which shifts to a creditor primacy model in a situation of financial distress or insolvency. It requires directors and officers to maximize corporate value for the benefit of the corporation's residual economic beneficiaries. The second model is the pluralistic decision-making model, adopted by the Supreme Court of Canada as the law in this country. It requires directors and officers to identify, consider and treat fairly all interests affected by the contemplated corporate decision. At play are the following two public policy objectives: promoting economic activity for the general benefit of society; and protecting stakeholder interests that may be prejudiced in a socially unacceptable way from the pursuit of the first objective. This thesis prefers the shareholder primacy model, switching to a creditor primacy model in financial distress or insolvency. The underlying rationale for this preferred model is maximization of corporate value for the greatest number, thereby promoting economic activity. Stakeholder interests are not sacrificed as there exists an extensive system of statutory protections supplemented by common law and equity.

Keywords: corporations, director's duties, officer's duties, best interests of the corporation, insolvency, vicinity of insolvency, zone of insolvency, near insolvency, twilight of insolvency, financial distress, shareholder primacy, pluralism, duty shifting, oppression remedy, shareholders, creditors.

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CHAPTER 1

INTRODUCTION

This thesis focuses on what it means for directors and officers to act in the best interests of the corporation. However, it is instructive first to review the legal basis for a corporation and the role assigned to directors and officers within a body corporate. This will provide the necessary context for examining what it means for directors and officers to act in the best interests of the corporation.

Corporations are creatures of statute. Corporate statutes have been established by all Canadian provinces and territories and the government of Canada. These acts govern the incorporation, internal structure, and conduct of the business and affairs of corporations that are incorporated thereunder. The provisions of these various corporate acts are similar. Thus, a review of the provisions of only one of these statutes is required for an understanding of the conceptual framework of a corporation in Canada. For example, under the *Canada Business Corporations Act*,[1] ("*CBCA*") one or more individuals may incorporate an entity for the purpose of carrying on business.[2] This entity is a corporation and it is thereafter given the "capacity" and "rights, powers and privileges of a natural person".[3] As a corporation is given the status of a natural person, one or more bodies corporate may in turn incorporate another body corporate for the

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[1] *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as amended [*CBCA*]. Approximately 50% of Canada's largest business corporations have been incorporated under the *CBCA*. See online: Industry Canada <http:\\www.ic.gc.ca\eic\site\clip-pdci.nsf\eng\h_cl00022.html> [Industry Canada Website].

[2] *Ibid.* at s. 5(1) and s. 15(2).

[3] *Ibid.* at s. 15(1).

purpose of carrying on business.[4] The statutory process that is to be followed for creating a corporation, being its own legal person, is quick, simple, and inexpensive. Step-by-step guidance is provided on Industry Canada's internet website.[5] Forms entitled Articles of Incorporation, Initial Registered Office Address and First Board of Directors are to be completed and filed along with the requisite fee. If the incorporated entity is to have its own name, as opposed to simply being known by the number that is assigned to it by Industry Canada upon incorporation, then approval of the proposed corporate name also is to be requested. This request for approval is done by filing a completed Corporate Name Information form and a search report from the Newly Upgraded Automated Name Search database confirming that the chosen name has not already been given to a body corporate.

The statutory creation of a corporation as a separate legal person is not a new phenomenon. It is also not unique to Canada but is equally applicable in the United States and all commonwealth jurisdictions. As far back as 1844, the United States Supreme Court wrote that:

> A corporation created by a state…though it may have members out of the state, seems to us to be a person, though an artificial one, inhabiting and belonging to the state, and therefore entitled, for the purpose of suing and being sued, to be deemed a citizen of the state.[6]

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[4] *Ibid.* at s. 5(2).

[5] Industry Canada Website, *supra* note 1.

[6] *Louisville, Cincinnati & Charleston Railroad Co. v. Letson,* 43 U.S. 497 (1844) at 555 as quoted in Leonard I. Rotman, "Debunking the 'End of History' Thesis for Corporate Law" Boston College International and Comparative Law Review [forthcoming 2010 available SSRN: <http://ssrn.com/abstract=15178467>] at 9.

As the House of Lords wrote in 1897:

> ...once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself...[7]

Thus, corporations are given status as separate legal entities, but they are inanimate business creatures in that they do not have an organic mind of their own. It is the people behind the corporation – i.e., its directing minds – that dictate its behaviour and its relations with third parties. The *CBCA* provides that the directors of a corporation are its first directing minds. They are elected by the shareholders[8] and are responsible for managing, or supervising the management of, the business and affairs of the corporation.[9] They may appoint a managing director, or committee of directors, and delegate any of their powers to such managing director or committee.[10] They also may designate offices of the corporation, such as the offices of Chief Executive Officer, Chief Financial Officer, President, Vice-President, and Secretary-Treasurer. They may specify the duties of these offices, appoint persons as officers, including themselves, and delegate to these officers their powers to manage the business and affairs of the corporation.[11] As such, it is the directors and officers of a company that end up being its directing minds or managers after it is incorporated and organized.

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[7] *Salomon v. Salomon* (1896), [1897] A.C. 22 (H.L.) at 30 [*Salomon*], as quoted in Rotman, *ibid.*

[8] *CBCA*, *supra* note 1 at s. 106(3).

[9] *Ibid.* at s. 102(1).

[10] *Ibid.* at s. 115(1).

[11] *Ibid.* at s. 121(a), (b), and (c).

The involvement of corporations, and directors and officers who give them their personality, in Canadian economy and society is significant. Individuals interact with corporate entities and corporations interact with other corporations on a daily basis. Those persons who have an interest that may be affected by the conduct of the corporation, such as shareholders, employees, suppliers, creditors, consumers, the government, and the general public in protecting the environment, are commonly referred to as corporate stakeholders. Given the pervasiveness of the corporate body in our society, and the plurality of interests that it affects, the question has arisen as to what role corporations should play in society. This question "has existed almost as long as the modern corporation itself".[12] It has generated a long-standing and continuing academic debate. The debate in the 1930s between Adolf Berle of Columbia University and Merrick Dodd of Harvard University is often cited as having initiated this long-standing discourse over "corporate governance that remains alive and well".[13] The preoccupation, at the state level, with the question of what role a corporation should play in society is evident from the significant amount of provincial and federal legislation that has been enacted to regulate corporate conduct. To state the obvious, if we want corporations to conduct themselves in a certain way, then we need to influence the behaviour of their directing minds, being their directors and officers. In this regard, as explained in more

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[12] Rotman, *supra* note 6 at 7.

[13] *Ibid.* at 3 and 10-12. This essay was posted online at SSRN on December 4, 2009.

detail in the body of this thesis, the law imposes on directors and officers a paramount general duty to govern with a view to acting in the best interests of the corporation.[14]

The roles, responsibilities, duties, and liabilities of directors and officers that are under examination in this thesis apply equally to both as managers of the corporation. For ease of reference, the balance of this paper will refer only to directors, understanding that what is written in respect of them applies equally to officers.[15]

I now turn to the primary question explored by this thesis. What does it mean for directors to act in the best interests of an inanimate corporate body? Does it mean governing so as to maximize the economic value of the corporation for the ultimate benefit of those persons with share capital in the corporation? These persons are the shareholders of the corporation. Should this duty shift to maximizing economic value for the benefit of the corporation's creditors, as the corporation's residual beneficiaries, when

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[14] As the Supreme Court of Canada wrote in *BCE Inc. v. 1976 Debentureholders,* [2008] 3 S.C.R. 560 at para. 81 [*BCE*], "...it is important to be clear that the directors owe their duty to the corporation...[to] act in the best interests of the corporation...".

[15] This thesis considers the statutory duties that apply equally to directors and officers under s. 122(1)(a) and (b) of the *CBCA*, *supra* note 1, being, respectively, the duties to act honestly and in good faith with a view to the best interests of the corporation and to exercise the care, diligence, and skill of a reasonably prudent person in the circumstances. This thesis also considers the provisions of s. 241(1), (2), and (3) of the *CBCA*, *supra* note 1, known as the oppression remedy. These provisions apply equally to directors and officers and give rise to a broad discretionary power in judges to fashion an appropriate remedy for a complainant when the conduct of directors and officers is found to oppress or unduly disregard or prejudice the "interests of any security holder, creditor, ...". This remedial power includes the power to impose personal liability on directors and officers. Directors and officers need to be respectful of, and honour, the reasonable expectations of shareholders and creditors, failing which they may be subjected to an oppression remedy that might include personal liability. It is noted that the provincial corporations acts have similar oppression remedy provisions as under the *CBCA*. This thesis also examines additional statutes that are designed to impose liability on both directors and officers with a view to influencing how they conduct the business and affairs of the corporation... From a practical perspective, officers will play a role in the management of the business and affairs of the corporation based on the nature and scope of the offices that they occupy. Thus, they form part of management of the corporation and to have effective laws seeking to promote good corporate behaviour officers as well as directors must be targeted..

the corporation is in the "vicinity of insolvency"[16] or is insolvent? The former is known as the shareholder primacy model and requires decisions to be made from the perspective of what would be in the best economic interests of the shareholders, and the latter is known as the creditor primacy model and requires decisions to be made from the perspective of what would be in the best economic interests of the creditors. Alternatively, does it mean governing in such a way as to consider, balance, and treat fairly the plurality of stakeholder interests that are affected by the corporation, known as the pluralistic model, rather than focusing on one set of interests? These are the questions that this paper analyzes and seeks to answer.

In *Peoples Department Stores Inc. (Trustee of) v. Wise,*[17] the Supreme Court of Canada displaced the traditional shareholder primacy model as the prevailing corporate decision-making model and rejected the emerging judicial trend toward recognizing a creditor primacy model when a corporation enters the "vicinity of insolvency" or becomes insolvent. Instead, the court favoured a pluralistic corporate decision-making model under all circumstances. The Supreme Court of Canada elaborated upon its conception of the pluralistic decision-making model in *BCE*[18] and, in so doing, held that affected stakeholders are entitled to reasonably expect to be treated fairly in the decision-making process, thereby making mandatory what had been a permissive pluralistic decision-making model. The end result is that more stakeholder protection is achieved by

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[16] "Vicinity of Insolvency" is the phrase that was used by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise,* [2004] 3 S.C.R. 461 at para. 46 [*SCC People's*]. The court dismissed the concept as being incapable of having a legal definition. The court nonetheless noted that "[w]hat it is intended to convey is a deterioration in the corporation's financial stability". Chapter 8 of this paper argues that "vicinity of insolvency" is capable of legal definition.

[17] *Ibid.*

[18] *BCE*, *supra* note 14.

directors being required to consider the community of affected interests in the corporate decision-making process.

This thesis argues that the shareholder primacy model, shifting to a creditor primacy model when a corporation is in the "vicinity of insolvency" or is insolvent, which was rejected by the Supreme Court of Canada, is a better model than the pluralistic decision-making model. The Supreme Court did not perform a comparative analysis of the competing models to determine which model was best-suited for meeting the public policy objective of promoting economic activity. The court did not undertake a detailed analysis of whether existing statutory law, common law, and equity afforded corporate stakeholders sufficient protection, thereby making it unnecessary for the court to add an additional layer of stakeholder protection by way of the pluralistic model. The court did not consider the competing models to determine which of them provided directors with a greater degree of certainty as to how they are expected to conduct themselves. Put another way, no thought appears to have been given as to whether ambiguity or uncertainty rendered the pluralistic model ineffective.

This paper argues that the shareholder primacy model did not need to be displaced as it is better suited than the pluralistic model for generating economic activity for the well-being of society, without sacrificing stakeholder interests which are sufficiently protected by existing statutory laws and regulations. There already existed a legislative balance between generating economic activity, through the principle of maximizing the economic value of the corporation for its shareholders, and protecting stakeholder interests that are deemed worthy of protection. It was not necessary for the court to give more weight to protecting stakeholder interests, especially without an analysis of existing

protections and the consequences of having more protection. A preference for the rationale behind the shareholder primacy model also supports a shift to maximizing the economic value of the corporation for the creditors when a corporation enters the "vicinity of insolvency" or becomes insolvent resulting in the shareholders having likely lost the value of their investments. Striving to maximize the economic value of the corporation for the economic class with the residual, or last, economic interest in the corporation requires providing an economic return to all other classes of economic interests in priority thereto.

In this paper, references to maximizing corporate value, or maximizing a corporation's value, mean conducting the business and affairs of the corporation in the best economic interests of the stakeholder with the residual economic interest in the corporation. This will be the shareholders, unless the financial condition of the corporation is such that the shareholders have likely lost their investments, in which case the class of unsecured creditors becomes the residual beneficiaries. Inherent in this meaning of maximizing corporate value is that the conduct of the business and affairs of the corporation will be in the economic best interests of the greatest number of economic classes of interests in the corporation. This is a utilitarian concept.

In contrast to the shareholder primacy model, the pluralistic model does not provide directors with a clear focus and is ambiguous. It is easier for directors, who are assumed to be practical business people, to understand and implement a strategy that focuses on one set of economic interests — those of the residual beneficiary — instead of a plurality of interests. Furthermore, the pluralistic model requires directors to balance

conflicts among competing economic interests without guidance as to how to resolve conflicts among competing interests.

The position taken in this paper in favour of a shareholder primacy model, shifting to a creditor primacy model when a corporation enters the "vicinity of insolvency" or becomes insolvent, is not to be taken as arguing for the maximization of corporate value as an absolute or overriding norm. To the contrary, it is but an important principle that forms the foundation of an already existing pluralistic decision-making model that is created by the state with a view to creating a balance between promoting economic activity and protecting stakeholder interests. As Adam Winkler explains,

> Despite the common conception of corporate governance as pertaining to shareholder-management relations, the actual decision making of corporate officers is heavily constrained by legal rules from outside of corporate law...One must take into account environmental law, labour law, civil rights law, workplace safety law, and pension law, lest one be left with the distorted and incomplete view of how the law actually shapes those corporate decision matrices.[19]

In order to support the thesis of this paper, it is presented in ten chapters. The first and last chapters are the introduction and conclusion, respectively. Chapter 2 explains that when a corporation is fully capitalized, is performing well, and has good prospects, directors have at their disposal sufficient economic resources to satisfy the economic interests of the corporation and its stakeholders. Thus, these interests tend to be aligned in the pursuit of the objectives for which the entity was incorporated. No issue arises as to whether directors should be working to maximize corporate value for

[19] Adam Winkler, "Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History" (2004), 67 Law & Contemp. Probs. 109 at 133 [Adam Winkler, "Corporate Law"], as quoted and cited in Rotman, *supra* note 6 at 62.

shareholders or creditors or whether directors should be making decisions based on balancing and treating fairly affected stakeholder interests. However, this equilibrium is disturbed when directors do not have the luxury of access to sufficient operating funds, whether from revenue, financing, or liquid assets, to satisfy all economic stakeholder interests. Financial distress gives rise to conflict between the economic interests of the corporation and its stakeholders and as between stakeholders. How this conflict should be resolved by directors makes relevant the question of what it means for directors to act in the best interests of the inanimate corporate body that they serve.

It is not just the conflict between competing interests arising in circumstances of financial distress that makes relevant the question of what it means for directors to act in the best interests of the corporation. It is any conflict between the corporation and its stakeholders or as between stakeholders that is in need of resolution that makes this question relevant. For example, the corporate takeover scenario also may present a conflict – typically between shareholders and creditors – that requires interpretation of what it means for directors to act in the best interests of the corporation. As noted above, the law in Canada as to what it means for directors to act in the best interests of the corporation is primarily the result of jurisprudence resulting from the Supreme Court of Canada's decisions in *People's*, a case dealing with what it means for directors to act in the best interests of the corporation in a "vicinity of insolvency" or insolvency situation, and *BCE*, a case dealing with what it means for directors to act in the best interests of the corporation in a corporate takeover situation.

Chapter 2 concludes by observing that the scope of affected interests, and the potential impact on society at large, would appear to be greater in a "vicinity of

insolvency" or insolvency scenario. It adds that, as such, what it means for directors to act in the best interests of the corporation is an important societal question that needs to be answered.

Chapter 3 is the longest chapter of this paper and contains the crux of the argument in favour of the shareholder primacy model, shifting to a creditor primacy model in a "vicinity of insolvency" or insolvency situation. It will examine the underlying academic debate. Chapter 3 will review the conceptual and pragmatic arguments in the debate. It will accept the conclusion of other authors that the pragmatic debate, comparing the consequences of each model on social welfare, has arisen largely as a result of the conceptual debate being indeterminate.

Special attention will be given to the practical argument in favour of the shareholder primacy model, since it is based on the shareholders having the residual, or last, economic interest in the corporation. By striving to maximize corporate value for the shareholders, all other classes of economic interests in priority to the shareholders also benefit. Accepting this maximizing-corporate-value-for-the-greatest-good principle means that, in a situation where the corporation is in the "vicinity of insolvency" or is insolvent, and thus the shareholders have likely lost their investments, the creditor class becomes the residual beneficiary. At that point, maximizing corporate value for their benefit will result in protecting the economic interests of the most number of classes of corporate stakeholders.

Chapter 3 concludes that, on balance, the shareholder primacy model is preferable because it is better-suited to achieve the public policy objective of promoting economic

growth without jeopardizing the public policy of preventing or limiting the hazards that are generated by pursuit of economic growth. These hazards are addressed through regulation, including the statutory law of oppression.

Chapter 4 looks at the jurisprudence arising from the courts in Delaware in respect of what it means to act in the best interests of the corporation. As explained in this chapter, the Delaware courts are generally recognized as an authority on company law principles. The law of Delaware prefers the shareholder primacy model, switching to a creditor primacy model in a "vicinity of insolvency" or insolvency situation, over the pluralistic model. As such, the jurisprudence arising from the Delaware courts is relied on in this paper for persuasive value.

Chapter 5 provides a review and analysis of the statutory oppression remedy. The statutory oppression remedy seeks to influence the behaviour of directors. It gives judges the discretionary power to fashion an appropriate remedy in circumstances where the conduct of directors is found to oppress shareholders and creditors, two major corporate stakeholders, or to unduly disregard or unduly prejudice their interests.[20] I argue in this chapter that the statutory oppression remedy gave rise to a pre-existing form of statutory pluralism, which made it unnecessary for the Supreme Court of Canada to adopt a pluralistic definition of what it means for directors to act in the best interests of the corporation insofar as shareholders and creditors are concerned. In particular, given the existence of the oppression remedy, it was unnecessary for the Supreme Court of Canada to interpret broadly a director's duty to act in the best interests of the corporation in order to address the grievance of the creditors in *People's* and the dispute between the

[20] *CBCA*, *supra* note 1 at s. 241(1), (2), and (3).

bondholder creditors and shareholders in *BCE.* Ironically, in neither case did the creditors benefit from a pluralistic corporate decision-making model.

As the oppression remedy gives rise to a statutory form of pluralism, I undertake a comprehensive analysis of the law of oppression. The two-part test established by the Supreme Court of Canada in *BCE* for applying the oppression remedy will be reviewed. The first part of the test involves an examination of whether the complainant has a reasonable expectation to be protected. The second part of the test examines whether the reasonable expectation was oppressed, unduly disregarded, or unduly prejudiced, by the conduct of the director.

Chapter 5 also examines the concept of "complainant", being the entity that is entitled to invoke the oppression remedy, and what constitutes directorial conduct that is oppressive or that unduly disregards or unduly prejudices a reasonable expectation that is found to exist. This chapter also notes that, under the oppression remedy, personal liability is imposed on directors in order to influence their behaviour to consider the reasonable expectations of shareholders and creditors in their decision making. The judicial trend is to impose personal liability on directors when there has been some conduct considered by the court to be inappropriate, despite the fact that, under the law of oppression, it is not necessary to find inappropriate conduct for judicial intervention and the imposition of personal liability.

Chapter 5 concludes by addressing the influence of the law of oppression on the Supreme Court of Canada in its development of the concept of what it means for directors to discharge their duties to act in the best interests of the corporation. The court

in *BCE* adopted oppression remedy principles in defining "acting in the best interests of the company" by noting that directors are obligated to treat all individual stakeholders fairly in the corporate decision-making process as that is what individual stakeholders are entitled to reasonably expect.

Chapter 6 undertakes an analysis and critique of the decisions of the Supreme Court of Canada in *People's* and *BCE,* with the ultimate view of formulating a statement of the law in Canada of a director's duty to act in the best interests of the corporation. These decisions rejected the traditional shareholder primacy model and the emerging judicial trend toward a creditor primacy model when a corporation entered the "vicinity of insolvency" or became insolvent, in favour of a pluralistic corporate decision-making model. Chapter 6 demonstrates that the corporate pluralistic decision-making model that is the law in Canada is intricate and complicated, and arguably too intricate and complicated for directors to understand and be able to implement effectively.

Chapter 7 reviews the legal principle often referred to as the business judgment rule. This concept dictates that judges should be careful in disturbing the business judgment that is exercised by directors. It is meant to prevent hindsight bias and is an acknowledgment that judges are not by nature experienced corporate managers. Thus, the business judgment rule requires judicial deference to be granted to decisions that are made by directors. However, this is not an absolute deference and such decisions may be subject to judicial intervention. Chapter 7, therefore, examines the test that is to be applied in examining the decisions of directors, as corporate decisions must pass this test in order not to be disturbed. Directors must be aware of this test and must meet its requirements in order for their decisions to pass muster. As such, the test for when a

corporate decision will be granted judicial deference further defines how and to what extent directors and officers are to consider stakeholder interests as part of a pluralistic decision-making model.

The thesis of this paper is that the corporate decision-making model should be the shareholder primacy model, shifting to a creditor primacy model when a corporation is in the "vicinity of insolvency" or is insolvent, as modified or augmented by statutory laws and regulations. Thus, in order to support this thesis, "vicinity of insolvency" must be capable of being defined, as that is when the shift is to take place from a shareholder primacy model to a creditor primacy model.

Chapter 8 tackles the difficult question of defining "vicinity of insolvency" and argues that it can be defined. Insolvency is a defined statutory term. There exists a body of law that interprets this concept. Accordingly, directors know what an "insolvency" is and can appreciate when the corporation is faced with a material risk of insolvency. In any event, the law has no hesitation applying an objective test to determine whether a director's duties have been breached. As such, there should be no hesitation in applying an objective test for determining if a corporation's risk of insolvency has become material and the directors were or reasonably ought to have been, aware of this material risk.

It is important that a line be drawn as to when a corporation is in the "vicinity of insolvency". From a public policy perspective, it is at that time that directors need to change their thinking to a more conservative corporate recovery strategy benefiting the creditors, as the residual beneficiary class, and the greatest number of economic classes

of stakeholders. A speculative corporate recovery strategy, for example, with a view to recouping the lost investment of the shareholders, would run too high a risk of a complete corporate failure, thereby prejudicing all classes of stakeholders.

Chapter 9 considers a factual example of a corporation that is in financial distress to illustrate the position in which directors will find themselves and how the principles that are considered in this paper might affect their decision-making process. Chapter 10 concludes this paper. It provides a summary of the discussion and conclusions that are reached in the preceding chapters. It formulates a proposed statement of law for what it means for directors to act in the best interests of the corporation.

CHAPTER 2

THE SIGNIFICANCE OF FINANCIAL DISTRESS OR INSOLVENCY

Why is a corporation's financial status, or health, relevant to how directors manage the business and affairs of the corporation? It is relevant because financial distress may give rise to competing interests among the corporation, its shareholders, and its creditors, which the directors are to reconcile in the corporate decision-making process. As the Supreme Court of Canada recognized in *People's*, "[t]he interests of shareholders, those of creditors and those of the corporation may and will be consistent with each other if the corporation is profitable and well capitalized and has strong prospects. However, this can change if the corporation starts to struggle financially."[21]

This "change" in financial status, giving rise to the possibility of competing interests among shareholders, creditors, and the corporation, has been said to occur when the corporation enters the "vicinity of insolvency".[22] However, the Supreme Court of Canada in *People's* dismissed the concept of "vicinity of insolvency" as being incapable

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[21] *SCC People's*, *supra* note 16 at paras. 44-45. *People's* was a case dealing with a subsidiary financing the purchase of inventory for its parent corporation on terms that were favourable to its parent corporation to the detriment of its own creditors in a "vicinity of insolvency" or insolvency situation. A more detailed explanation of the facts and analysis of this case will be found in Chapter 6 below.

[22] A considerable amount of literature exists regarding the concept of the "vicinity of insolvency". It also is sometimes referred to as the "zone of insolvency", "near insolvency", or "twilight of insolvency" to denote when directors need to be cognizant of the competing interest of creditors. See, for example: Scott Bomhof, "Duties of Directors in the Insolvency Zone" (October 2009), online: Torys.com <http//www.torys.com/publications/documents/publications%20PDFs/AR2009-51.pdf>; Jonathan T. Edwards and Andrew D. Appleby, "The Twilight of Insolvency: New Developments in Fiduciary Duty Jurisprudence that May Affect Directors and Officers while in the Zone of Insolvency" (2009), 18 J. Banks. L. & Prac. 3 ART. 2.; Cory Dean Kandestein, "The Duty to Creditors in Near-Insolvent Firms: Eliminating the 'Near Insolvency' Distinction" (2007), 60 V. and L. Rev. 1235.

of having any legal definition. Nonetheless, the court noted that "[w]hat it is intended to convey is a deterioration in the corporation's financial stability".[23] Thus, the economic interests of the corporation and some of its stakeholders may begin to compete upon a "deterioration in the corporation's financial stability" or when a "corporation starts to struggle financially".

Edward M. Iacobucci[24] arrived at this conclusion in an article that was published prior to the Supreme Court of Canada's decision in *People's*. Iacobucci pointed out that a director's paramount duty is to act in the best interests of the corporation and, "in a perfect world," this amounts to a duty to maximize the economic value of the corporation for the benefit of the corporation and its stakeholders.[25] Iacobucci, therefore, concluded that there is a general absence of opposing interests among shareholders, creditors, and the corporation as to what is in the best interests of the corporation.[26] Iacobucci noted that a conflict arises among the interests of the corporation and its shareholders and creditors when directors are faced with having to make "safe or risky" investment decisions presented by circumstances of financial distress or insolvency.[27] In an insolvency or financial distress situation, the general assumption is that "safe" or more conservative financial decisions would be better for the corporation and its creditors.

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[23] *SCC Peoples*, *supra* note 16 at para. 46. Chapter 8 below argues that "vicinity of insolvency" is capable of being defined.

[24] Edward M. Iacobucci, "Directors' Duties in Insolvency: Clarifying What Is At Stake" (2003), 39 Can. Bus. L.J. 398 [Iacobucci, "Directors' Duties"].

[25] *Ibid.* at 400-401.

[26] *Ibid.* at 399 and 405.

[27] *Ibid.* at 405.

Such an approach is seen as being more likely to preserve the economic value of the corporation.

This general assumption, that in a situation of financial distress or insolvency creditors and the corporation are better served by conservative measures to deal with the circumstances, is premised on the existence of the following three factors:

(a) little or no equity available in the corporation for the shareholders, or, at a minimum, the situation being one of rapidly diminishing equity;

(b) the creditors thus displacing the shareholders as the class with the residual, or last, economic interest in the value of the company's business or assets; and

(c) the interests of the creditors in protecting their economic investment being better served by a conservative restructuring strategy to preserve the value of the corporation as a going concern business[28] or by winding it down and liquidating its assets without further diminution in value.

This third factor is to be contrasted with a more aggressive restructuring approach, which might be preferred by shareholders who have lost their investments and are looking for the best opportunity of recovery. More aggressive measures might give rise to a better result, but have less chance of success, and thus create too high a risk of economic resources being wasted. In other words, having lost their investments, shareholders might be more inclined to gamble existing economic resources otherwise available to other economic stakeholders to recover their losses as they would have no downside.

[28] Insolvency practitioners refer to corporate restructuring measures with a view to maintaining the corporation as a going concern business as a "turn around" or "corporate rescue" exercise, reflecting the goal of reversing the financial decline of the corporation and, thus, saving it.

Failure in this high risk approach would result in a significant or complete diminution in the residual value of the corporation that otherwise would have been available for the creditors and all other classes with an economic interest in the corporation.

Sabin Willett writes that a "director's dilemma" arises when a corporation is in financial distress and directors are faced with having to decide between a conservative corporate rescue plan that favours creditors and a more aggressive one that favours shareholders. Willett notes that corporate valuations are inherently uncertain, as they are based on assumptions and projections. Thus, directors' predictions about how a corporation's value will be affected by different options may not necessarily be accurate. Willett adds that the dilemma becomes more pronounced if the plan that favours shareholders is assessed at even, or close to even, chances of success.[29] The point that is highlighted by the "director's dilemma" is that directors are required to make difficult decisions in an environment of uncertainty when the corporation is in a situation of financial distress or insolvency. Directors are required to use their business judgment in deciding what it means to act in the best interests of the corporation in circumstances of competing interests.

In addition to the "vicinity of insolvency" or insolvency situation, there are other scenarios that may give rise to competing corporate and stakeholder interests for directors to reconcile in exercising their business judgment to act in the best interests of the

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[29] Sabin Willett, "Gheewalla and the Director's Dilemma" (2009), 64 The Business Lawyer 1087. Willett refers to conservative measures to maintain a distressed corporation as a going concern for the benefit of creditors as "enterprise maximization" versus more aggressive measures for the benefit of shareholders, which is referred to as "equity preservation". Willett argues that directors should always decide in favour of equity preservation measures for shareholders as this would be "more faithful" to the traditional fiduciary duty to act in the best interests of the shareholders as reaffirmed by the Delaware Supreme Court in *North American Catholic Education Programming Foundation, Inc., v. Gheewalla,* 930 A.2d 92 (Del. Sup. Ct. 2007) [*North American Catholic*].

corporation. For example, the corporate takeover scenario also may give rise to a dilemma for directors in deciding how best to exercise their business judgment. In a corporate takeover scenario, shareholders and creditors may disagree on a proposed method of dealing with the shares or assets of the corporation, thereby placing directors in the middle of a dispute among corporate stakeholders. This conflict has allowed courts an opportunity to further examine what it means for directors to act in the best interests of the corporation in the face of competing interests.

In particular, the Supreme Court of Canada in *BCE,* a leading case dealing with a corporate takeover scenario, recognized again that "[o]ften the interests of the shareholders and stakeholders are co-extensive with the interests of the corporation".[30] In that case, these interests would have continued to be "co-extensive" but for the contemplated purchase and takeover of the corporation. Thus, directors face the same potential dilemma, whether the change is caused by a deteriorating financial situation or a corporate takeover. They will be required to reconcile potentially conflicting stakeholder interests in determining what is in the best interests of the corporation because the contemplated course of action may not benefit stakeholders equally and those stakeholders negatively affected may dispute the approach being proposed. Further, the same legal test, or standard, applies in how directors should address the plurality of interests at play in acting in the best interests of the corporation.

The conflict between shareholders and creditors that the directors had to reconcile in the context of a corporate takeover is well-illustrated in *BCE.* The directors in *BCE* faced criticism by BCE's debenture holders, who objected to a decision of the directors to

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[30] *BCE, supra* note 14 at para. 37.

approve a leveraged sale of the corporation's shares. The leveraged buy-out would be of financial benefit to the shareholders, but it would result in a reduction in the credit rating and market value of the bonds that were held by the debenture holders. This adverse effect on the bonds was due to increased debt that was to be incurred by the corporation under the terms of the leveraged buy-out. The proposed transaction was expected to result in a drop of approximately 20% in the trading value of the bonds versus an approximate 40% increase in the market price of common shares that were held by shareholders. The directors had to make a decision: obtain the highest possible share price for shareholders or maintain the credit rating and value of bonds for debenture-holder creditors? The court held that the decision of the directors, which favoured the shareholders over the debenture holders, did not "oppress" the debenture holders and that the best interests of the corporation "arguably favoured" accepting the buy-out offer.[31] Nonetheless, but for the disturbance that was caused to normal relations among the directors and shareholders and creditors by an out-of-the-ordinary event, the interests of the shareholders and debenture holders would not have presented a conflict.

The impact on social welfare, and the community within which the corporation carries on business, is likely more significant where directors have to reconcile competing stakeholder interests in a situation of financial distress or insolvency, as opposed to a corporate takeover situation. In a financial distress or insolvency situation, directors are required to allocate economic resources among interested parties where

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[31] *Ibid.* at para. 112. While the court in *BCE* addressed the concept of a director acting in the best interests of the corporation, that was technically not an issue that was before the court. The debenture holders had structured their complaint on the basis that the leveraged buy-out either oppressed them under the oppression remedy, or court approval thereof, as an arrangement under s. 192 of the *CBCA*, *supra* note 1, should not be granted as it was not "fair". See Chapter 5 below for a detailed analysis of the oppression remedy.

demand exceeds supply. This deficiency will result in prejudice to those stakeholders whose economic interests are not fulfilled. The breadth and scope of the negative impact of financial distress or insolvency on society is self-evident from a simple observation of some of the consequences that arise when a corporation does not have sufficient cash flow, whether from operations or financing, to pay its corporate obligations in a timely way. For example, it may mean that:

(a) Goods and Services Tax, retail sales tax, corporate income tax, and employee source deductions are not remitted to the government to fund government programs and initiatives for the public;

(b) employees are not paid their wages or vacation pay and may lose their jobs and, thus, no longer have a continuing income and access to group health and medical benefits, and employee pensions are no longer funded by employer contributions, and perhaps may be left underfunded;

(c) suppliers of goods and services will not get paid what they are owed and may lose a future income stream;

(d) landlords may be not be paid arrears of rent and may lose an ongoing rental income stream;

(e) leasing companies and secured creditors will not get paid what they are owed and may lose the balance of the return on their investments;

(f) shareholders will suffer a loss of their economic investments; and,

(g) the corporation cannot pay for any environmental remediation costs due to environmental contamination that is caused by operations.

The adverse effects of these consequences are not limited to stakeholders. They also affect persons who are economically dependent on stakeholders, like family members. It is, therefore, worthwhile to examine how the law requires directors to govern themselves and the corporation in cases of financial distress or insolvency in order to assess the extent to which the existing state of the law creates a socially desirable result or could use some improvement.

In summary, when a corporation is performing well financially, directors manage a situation where the corporation is able to satisfy the economic interests of both the corporation and its stakeholders. However, this is likely to change when the corporation experiences financial difficulty or is insolvent, as competing interests arise. A director's role in managing in the face of competing interests is more complicated. Directors have to manage a situation where there is a shortage of available funds from operations and financing to meet both the corporation's needs and those of its stakeholders. Restructuring options to maintain the company as a going concern, if available, may affect competing economic interests differently. Corporate stakeholders may be assumed to want decisions made by directors that they perceive to be in their best interests. Lastly, the success of available restructuring options is uncertain and the repercussions on society are significant.

CHAPTER 3

THE ACADEMIC DEBATE: SHAREHOLDER PRIMACY v. PLURALISM

(A) General

It is a trite proposition of Canadian corporate law that a director owes a duty to the corporation to act in its best interests.[32] The academic debate about what this means has centered around two competing corporate decision-making models. The traditional model is the shareholder primacy model. It focuses on directors acting to maximize corporate value. Its competitor is the pluralistic decision-making model. It requires directors to consider the interests of all affected stakeholders in their decision making. The preceding chapter explained how the interests of the corporation and its stakeholders are generally aligned when the corporation is profitable, is well-capitalized, and has strong prospects, and how this changes and these interests are likely to begin to conflict when the corporation begins to experience financial distress. Each decision-making model brings a different approach to addressing the interests of the corporation and its stakeholders in a time of financial distress or insolvency. This chapter will review each model and compare the main arguments for and against each model, with special attention given to a situation of financial distress or insolvency, with a view to determining whether, on balance, one model is preferable over the other model.

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[32] See *BCE*, *supra* note 14, *CBCA*, *supra* note 1 at s. 122(1)(a), and Iacobucci, "Directors' Duties", *supra* note 24.

Mohamed F. Khimji[33] and Ian B. Lee[34] provide comprehensive summaries of the long-standing academic debate between the shareholder primacy and pluralistic models.[35] As the footnotes to both of these papers reveal, this debate has generated a significant amount of literature. Khimji points to the notable debate in the 1930s between A.A. Berle and E. Merrick Dodd on the question of: "For Whom Are Corporate Managers Trustees?"[36] Berle supported the shareholder primacy model, arguing that a corporation's responsibility is profit maximization within the law for the benefit of the shareholders. Dodd, drawing on the notion that a corporation is a legal person, supported pluralism and took the position that corporations are accountable to the general public and not just to shareholders. Twenty years later, Berle conceded Dodd's position that corporations are social institutions accountable to the public and accepted pluralism, but the debate continued as to whether to equate the best interests of the corporation with the best interests of the shareholders, considered to be profit maximization, or with the community of interests as represented by the general body of stakeholders.

Lee characterizes the debate as taking place on both a conceptual and pragmatic level. The conceptual debate is, in general, a confrontation between the concept that

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[33] Mohamed F. Khimji, "People's v. Wise – Conflating Directors' Duties, Oppression, and Stakeholders Protection" (2006), 39 U.B.C.L. Rev. 209.

[34] Ian B. Lee, "Corporate Law and the Role of Corporations in Society: Monism, Pluralism, Markets and Politics" (2006), 85 The Canadian Bar Review 1 [Lee, "Corporate Law"].

[35] See Khimji, *supra* note 33 at 215-217 and Lee, "Corporate Law", *ibid.* at 5-14. See also: Christopher C. Nicholls, *Corporate Law* (Toronto: Emond Montgomery Publications Limited, 2005) at 257-312; Kevin P. McGuiness, *Canadian Business Corporations Law*, 2nd ed. (Markham: LexisNexis Canada Inc., 2007) at 959-994; J. Anthony VanDuzer, *The Law of Partnerhships & Corporations*, 3rd ed. (Toronto: Irwin Law Inc., 2009) at 548-587; and Thomas W. Joo, ed., *Corporate Governance Law, Theory and Policy* (Durham: Carolina Academic Press) at 2-10.

[36] E. Merrick Dodd, "For Whom Are Corporate Managers Trustees" (1932), Harvard L. Rev. 1145. See summary by Khimji, *ibid.* at 209-210 and fns. 4-11.

shareholders are the owners of a corporation's business assets, thereby favouring a shareholder primacy model, versus the notion that incorporation is a concession, or privilege, which is granted by the state, thereby favouring pluralism.[37] The pragmatic debate arises because of the inconclusive nature of the conceptual debate and the rise of economic analysis of company law and focuses on whether social welfare is more likely maximized under the shareholder primacy or pluralistic model of corporate decision-making.[38]

(B) Conceptual Arguments

(I) Shareholder Primacy

The classic conceptual argument in favour of the shareholder primacy model is that corporations ought to be managed by the directors in the interests of the shareholders, as the shareholders are owners of the business assets that are used to carry on the corporate business. This classic argument views corporations as incorporated partnerships or incorporated sole proprietorships with the shareholders being the owners of the business who are actively involved in managing its business and affairs. Any corporate objective other than profit maximization in this scenario is an infringement of private property.[39]

However, this classic argument in support of shareholder primacy has been discredited, or at least neutralized, by a number of counter-arguments. As the size of

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[37] Lee "Corporate Law", *supra* note 34 at 5.

[38] *Ibid.* at 8.

[39] Khimji, *supra* note 33 at 215 and Lee, "Corporate Law", *ibid.* at 5-6.

corporations have grown, with increased numbers of shareholders being passive investors, the argument that is premised on the shareholders being in control of the business has become limited in application to closely-held private corporations. Further, regardless whether a corporation is a closely-held one or a large public one, it is arguable that directors are leaders of institutions with social responsibilities that go beyond profit maximization given the proliferation, pervasiveness, and impact on social welfare of incorporation as a vehicle for conducting business in our society.[40]

Another criticism of the ownership argument is that it is circular in nature. Property for a shareholder consists of a "bundle of rights". One such right may be the right to have directors manage the corporation with a view to maximizing profit and, thus, share value. However, to use the concept of ownership as the basis for the existence of this right is to assert the right without any justification for why it is or should be an incident of ownership.[41]

Lastly, the "shareholders as owners" argument is refutable based on the classic legal framework of incorporation. Shareholders have no interest in the assets of the corporation and it is the directors that are its directing minds. Shareholders only have ownership rights in relation to their shares, which give them certain rights as shareholders, such as the right to vote and to receive dividends, if declared, and the

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[40] Khimji, *ibid.* at 215 and Lee, "Corporate Law", *ibid.* at 6-7.

[41] Lee, "Corporate Law", *ibid.* at 7.

oppression remedy protects their reasonable expectations but does not translate to any proprietary rights in the corporation's assets.[42]

(II) Pluralism

The classic argument in favour of the pluralistic model is that corporations are brought into existence and sustained by legislative enactment, resulting in many private benefits and advantages for shareholders and, as these are privileges that are granted by the state, it is justifiable for the state to impose limitations or restrictions on them in favour of public responsibilities.[43]

However, this argument in favour of pluralism has been discredited, or at least neutralized, mainly by two counter-arguments. First, the general availability of incorporation makes it less of a special privilege that is granted by the state as it was in times when incorporation required a special Act of Parliament or a discretionary grant of letters patent by the state (sometimes with monopoly privileges).[44] Second, the prevailing or modern corporate law concept of a corporation is that it constitutes a series of voluntary relationships, or a "nexus of contracts", among directors and shareholders, directors and employees, directors and creditors, and directors and other stakeholders. Based on this theory of company law, the purpose of the state enacting general

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[42] Khimji, *supra* note 33 at 216.

[43] Lee, "Corporate Law", *supra* note 34 at 7.

[44] *Ibid.* at 8-9.

incorporation statutes is to provide a mechanism for directors and corporate stakeholders to manage their relationships and not to legislate preferential status.[45]

A review of the traditional theories for shareholder primacy and pluralism does not seem to result in one model making more conceptual sense than the other. In other words, a review of the traditional theories for the purpose of determining whether one model is more attractive than the other proves inconclusive or indeterminate. As such, the examination of whether shareholder primacy or pluralism is more desirable as a corporate decision-making model, and why, has evolved from a conceptual inquiry to a pragmatic one. The pragmatic analysis focuses on and compares the consequences for social welfare that are produced by these competing models.[46] A review of the pragmatic arguments for and against each of these models favours, on balance, the shareholder primacy model.

(C) Pragmatic Arguments

(I) Social Welfare v. Agency Costs

Defenders of pluralism argue that shareholder primacy gives rise to unacceptable social welfare costs. Non-shareholder interests will be compromised and prejudiced in the pursuit of maximization of corporate value. For example, employers will not agree to employee benefits that increase costs and decrease profits.

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[45] *Ibid.* at 9. An explanation and analysis of this "nexus of contracts" conceptualization of corporate law is found in Jason W. Neyers, "Canadian Corporate Law Veil–Piercing, in the Private Law Model" (2002), 50 U.T.L.J. 173 [Neyers, "Canadian Corporate Law"]. Neyers' essay is discussed below at pages 48-49.

[46] Lee, "Corporate Law", *ibid.* at 8.

Defenders of shareholder primacy counter that shareholder wealth and social welfare may be aligned to a considerable extent and, thus, this concern is over-stated. For example, directors realize that they must take into consideration the interests of employees, customers, and creditors. In order to make a profit, the corporation needs loyalty, patronage, and credit. Where directors do not have a sufficient incentive to take certain stakeholder interests into consideration, regulatory law designed to influence their behaviour by threat of personal liability will fill the gap.[47] Furthermore, as explained in Chapter 2, it would seem to be a generally accepted norm that, when a corporation is performing well financially, stakeholder interests are aligned. The potential for conflicting interests crops up when a corporation's financial situation begins to deteriorate or insolvency sets in.

Proponents of shareholder primacy add that pluralism imposes costs of its own. They refer to them as increased agency costs. In particular, the agency-cost argument against pluralism is that pluralism makes it difficult to analyze and evaluate the performance of directors in that you can look at the corporation's financial statements and stock prices to see whether a profit has been made, but there really is no similarly definitive marker to which one can look to determine whether the directors have succeeded in taking into consideration the interests of other stakeholders.[48] Another agency-cost argument against pluralism is that it results in accountability to different

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[47] *Ibid.* at 9. A detailed discussion of the role of regulatory law in influencing directorial behaviour is set out below at pages 50 -60.

[48] *Ibid.* at 9-10.

competing interests and that this amounts to accountability to nobody.[49] Such lack of accountability also gives directors the opportunity to pursue their own self-interests. In any event, lack of accountability increases the monitoring costs of all stakeholders in having to watch over directors to ensure that their interests are not prejudiced.[50]

There do not seem to be any empirical data comparing social welfare and agency costs. There may not be an objective measure of whether social welfare or agency costs are more significant. Lee concludes that the social welfare versus agency costs debate does not result in a winner, as the shareholder primacy model probably does not do a better job at controlling agency costs in any event. Lee points to the business judgment rule, which is reviewed in Chapter 7 below, as to why the shareholder primacy model may not be able to control agency costs. The business judgment rule allows directors a significant amount of latitude and flexibility within the profit maximization principle, and thus agency costs may arise in order to, for example, monitor the conduct of directors to insure that shareholder interests are advanced.[51]

It may not be possible to objectively weigh social welfare costs and agency costs, but agency costs arising under pluralism do highlight a different problem. Pluralism creates a less certain mandate for directors. Directors have to balance a plurality of interests without any clear objectives for measuring and evaluating performance. This

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[49] Khimji, *supra* note 33 at fn. 36 cites as authority for this proposition Ronald J. Daniels & Randall Morck, eds., *Corporate Decision Making in Canada* (Calgary: University of Calgary Press, 1995) at 8. Lee, "Corporate Law", *ibid.* at fn. 41 attributes the statement that "a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither" to F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) at 38.

[50] Lee, "Corporate Law", *ibid.* at 9-10.

[51] *Ibid.* at 10-11.

vague or uncertain aspect of the definition of pluralism in and of itself makes pluralism a less favourable model than the single purpose shareholder primacy model.

(II) Pluralism = Team Production

In support of pluralism, it is argued that a corporation's business success results from a "team production" where trust is important between the directors and all those who are committing resources to the enterprise and that this trust may be breached, and the integrity of the team weakened, in circumstances where maximization of corporate value necessitates breaching the trust.[52] However, like the question of whether social or agency costs are greater in magnitude, there do not appear to be any empirical data and there is no way of objectively measuring whether this added cost of shareholder primacy under the team production theory outweighs the agency costs that are associated with pluralism.[53]

(III) Shareholders are Residual Beneficiaries

(a) General

Supporters of the shareholder primacy model rely on the residual-claimants argument to support their case for shareholder primacy over pluralism. The shareholders as a class are said to have the residual economic interest in the corporation, in the sense that the shareholders receive a return on their investment only after the interests of all other economic stakeholders have been satisfied. Therefore, striving to operate a

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[52] Khimji, *supra* note 33 at 216 and Lee, "Corporate Law", *ibid.* at 13-14.

[53] Lee, "Corporate Law", *ibid.* at 14.

corporation so as to maximize corporate value for the shareholders means taking care of all other economic interests in priority to the interests of shareholders. Lee describes this argument as an attempt to break the impasse between the shareholder primacy and pluralism debate in favour of shareholder primacy, on the basis that maximization of corporate value for the benefit of the shareholders, by implication, benefits all.[54]

A criticism of this argument is that it assumes that maximization of corporate value cannot have a negative impact on non-shareholder stakeholders. Thus, it is too general a proposition as it fails to recognize that, under certain circumstances, maximization of corporate value will negatively affect the non-shareholder class of stakeholders.[55] Supporters of shareholder primacy respond to this criticism by acknowledging that there sometimes may be negative consequences on non-shareholder stakeholders, but they add that these consequences should be tolerated as a necessary by-product of maximization of corporate value because it is of benefit to most of the non-shareholder economic interests that are concerned. Further, these negative consequences can, in any event, be dealt with by laws and regulations that are imposed by the state for determining the socially desirable limits to the shareholder primacy model. Supporters of shareholder primacy also note that non-shareholder stakeholders have assumed the risks of maximization of corporate value for shareholders in the bargain that they reached with the corporation.[56]

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[54] *Ibid.* at 11.

[55] *Ibid.*

[56] Khimji, *supra* note 33 at 216 and Lee, "Corporate Law", *ibid.* at 12.

The shareholders-as-residual-beneficiaries argument, in favour of the shareholder primacy model, raises the following three questions:

(a) is maximization of corporate value, being the premise upon which the argument is founded, generally in the best interests of all stakeholders;

(b) if yes, then which model is better-suited for achieving maximization of corporate value; and,

(c) if it is the shareholder primacy model, then is there a sufficient network of laws and regulations in place to address the consequences that are deemed to be socially unacceptable and that result from maximization of corporate value.

(b) Maximization of Corporate Value is in Best Interests of all Stakeholders

Within our economic system, corporations are widely used as vehicles for carrying on business. Economic stakeholders are dependent on the corporate business vehicle to satisfy their economic interests. Striving to achieve an economic return for the stakeholder with the residual economic interest in the corporation by definition first requires satisfaction of all other the economic interests in the corporation. This approach of striving to maximize corporate value for the residual economic interest is significant because it satisfies the economic interests of the corporation's constituent stakeholders and has societal benefits beyond satisfying these immediate interests, for the general benefit of society. For example, some of the obvious benefits to society of the economic

interests of stakeholders being satisfied is that it results in access to funds which can be applied:

(a) by stakeholders to pay income and sales taxes owing to fund government programs and services for the benefit of society in general;

(b) by employers and employees, to make remittances on account of health taxes, the Canada Pension Plan, and unemployment insurance benefits;

(c) by employees, to earn incomes and, among other things, to provide for themselves and their dependents and reinvest in consumer goods and services, thereby further stimulating economic activity;

(d) by suppliers of goods and services, to generate an income to allow for the purchase of goods and services from other suppliers that are required to carry on business, to pay employees, and to satisfy the balance of their own economic stakeholders, thereby generating further economic activity;

(e) by lenders, for reinvestment or spending elsewhere, thereby generating further economic growth; and,

(f) by shareholders, for reinvestment or spending elsewhere, thereby generating further economic growth.

It may not be possible to maintain all of these societal benefits in cases of financial distress or insolvency. The preference would be to preserve as many of them as possible. Some form of economically-viable going-concern business will generate more

economic activity than one that is no longer in business. Thus, in a situation of financial distress or insolvency, restructuring measures that are designed to turn around the corporation's financial situation are preferable to a liquidation strategy. Whether the corporation is solvent, in the vicinity of insolvency, or insolvent, the maximization of corporate value principle is in the best economic interests of the corporation and all stakeholders and society. There is no doubt that generating economic activity is a fundamental public policy objective of corporate law. The maximization of corporate value principle is designed to satisfy the economic interests of stakeholders and results in general benefits for society. Which model is better-suited to achieve the maximization of corporate value principle?

(c) Which Model is Better for Increased Economic Activity?

As Mark J. Roe[57] points out, at the root of the shareholder primacy model, or the justification for having directors focus on maximization of corporate value, is a utilitarian "greatest good for the greatest number philosophy".[58] Under this principle, the economic stakeholders represent classes and the objective is to maximize corporate value for the most number of classes. This concept also gives rise to obvious democratic connotations, albeit based on democracy among classes of stakeholders. Any negative fall-out from maximization of corporate value,

> ...is the price to be paid for strong capital markets, and allocative efficiency and that these benefits are so powerful that they overwhelm the normative benefit of any distributional favouring

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[57] Mark J. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization" (2000-2001), 149 U. Pa. L. Rev. 2063.

[58] *Ibid.* at 2065.

> [of other stakeholders over] shareholders. In the long run, the argument goes, employees and other stakeholders are overall better off with fluid and efficient capital markets, managers need a simple metric to follow, and both wealth, and, in the end, fairness are maximized by the shareholders being the corporation's residual beneficiary…[59]

In rejecting the shareholder primacy model in favour of a pluralistic one, the Supreme Court of Canada in *People's*, followed by its decision in *BCE*, overturned the prevailing view of Canadian courts that a director's obligation to act in the best interests of the corporation meant maximization of corporate value.[60] Justice Pelletier of the Quebec Court of Appeal in *People's* exemplified the prevailing judicial view by overturning Justice Greenberg's trial decision as being contrary to the traditional shareholder primacy model. Justice Pelletier saw "the interests of the corporation as coinciding with the interests of all the shareholders in the pursuit of the objectives of the creation of the corporation".[61]

It would be difficult, if not impossible, to argue that the shareholder primacy, or profit maximization, model, which, as noted in the preceding paragraph, was the applicable legal corporate decision-making model before the Supreme Court of Canada's

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[59] *Ibid.*

[60] Janis Sarra, "The Corporate Veil Lifted: Director and Officer Liability to Third Parties" (2001), 35 Can. Bus. L.J. 55 at 56 [Sarra, "The Corporate Veil"].

[61] *Peoples Department Stores Inc. (Trustee of) v. Wise*, (2003), 22 D.L.R. (4th) 509 (Que. C.A.) at para. 82 [*People's CA*], rev'g (1998), 23 C.B.R. (4th) 200 (Que. S.C.) [*People's QSC*]..

decision in *People's*, did not promote economic activity for the benefit of society. This seems to have been the model's *raison d'être*. As David Goddard[62] has written,

> [i]n the field of commercial law, more than many other areas of law, we can say with some confidence that the economic benefits of an institution are co-extensive with its social benefits, and so with the policy rationale for its existence. The institution of the company, and the legal and administrative edifice that supports it, can be justified only by the economic benefits it creates. Absent those benefits, the institution's rationale is exhausted.[63]

In a situation of financial distress or insolvency, the shareholder primacy model becomes a misnomer for describing its underlying utilitarian or democratic rationale of the "greatest good for the greatest number" of classes of economic stakeholders. When the corporation is making a profit, is fully capitalized, and has a promising future all stakeholders benefit. In this regard, directors are striving to maximize corporate value for the shareholders, being the class with the residual economic interest in the corporation, which benefits all classes of economic stakeholders. However, in a situation of financial distress or insolvency, when there is little or no economic value in the corporation for the shareholders, the creditors displace the shareholders as the class with the remaining, or residual, economic interest in the value of the company. Striving to maximize corporate value for the creditor class as the residual beneficiaries benefits the most classes of stakeholders. Lee refers to the creditor primacy model as a qualified shareholder primacy model.[64] The creditor primacy model is also sometimes referred to as the duty shifting

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[62] David Goddard, "Corporate Personality – Limited Recourse and its Limits" in Charles E. F. Rickett and Ross B. Grantham, eds., *Corporate Personality in the 20th Century* (Oxford: Hart Publishing, 1998) 11 [Goddard, "Corporate Personality"].

[63] *Ibid.* at 17.

[64] Lee, "Corporate Law", *supra* note 34 at 3.

model. It calls for a shift from the traditional role that is recognized for directors, whereby acting in the best interests of the corporation is defined as acting to maximize corporate value for shareholders, to acting to maximize value for, and thus protecting, creditors' economic interests. The shift takes place in a deteriorating financial situation or in an insolvency situation.

The creditor primacy, or duty-shifting, model was developed in Commonwealth jurisdictions outside of Canada – i.e., Great Britain, Australia, and New Zealand – and was brought to the attention of the Canadian legal community by Jacob S. Ziegel in an essay that was published in 1993 entitled "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective".[65] This duty-shifting doctrine was subsequently accepted and applied by Justice Greenberg in 1998, as the trial judge in *People's QSC*.[66] Justice Greenberg found the directors of People's personally liable in the amount of $4.4 million on the basis that they had breached both their fiduciary duties and their duties of care. In so doing, Justice Greenberg cited Ziegel's 1993 paper, which referred to Commonwealth developments on the issue of a shifting duty that is owed to creditors, and concluded that Canadian corporate law should evolve in the same direction.[67]

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[65] Jacob S. Ziegel, "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective" (1993), 43 U.T.L.J. 511 [Ziegel, "Creditors as Corporate"].

[66] *People's QSC*, *supra* note 61.

[67] *Ibid.* at paras. 193, 202, and 205.

In coming to his conclusion, Justice Greenberg quoted and applied the following rationale, which was set out in Ziegel's essay, in support of extending the duty-shifting doctrine to Canada,

> It is not unreasonable, in exchange for the benefit of limited liability, to impose a duty on directors not to sacrifice creditors' interests when the going gets rough…if the company is insolvent, only the creditors still have a meaningful stake in its assets. This will be obvious if the company has been formally declared bankrupt. Why should it make a difference that bankruptcy has been delayed for a period of time? If we accept the paramountcy of creditors' interest when the company is insolvent, it must likewise be wrong, and a waste of economic resources, for the directors to continue to buy goods and services on credit knowing there is no reasonable prospect of the creditors ever being paid.[68]

As noted, Justice Pelletier, writing for a unanimous bench of the Quebec Court of Appeal,[69] rejected Justice Greenberg's extension of the duty-shifting doctrine to Canada. Justice Pelletier was not prepared to allow the traditional shareholder model to be qualified in circumstances of financial distress or insolvency.[70] The Supreme Court of Canada, for its part, rejected both the traditional shareholder primacy model and its variation, the creditor primacy model in circumstances of financial distress or insolvency, and endorsed a permissive pluralistic model.

It is important to note that the duty-shifting doctrine was developed as part of the judicial interpretation of a director's duty to act in the best interests of the corporation. It did not develop as part of the jurisprudence arising under the director's duty to take

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[68] *Ibid.* at paras. 203-204.

[69] *Peoples CA, supra* note 61.

[70] *Ibid.*

reasonable care so as not to cause others – i.e., corporate stakeholders – reasonably foreseeable harm. To illustrate this point, Brian Morgan and Harry Underwood[71] demonstrate how duty-shifting developed as a doctrine under the director's duty to act in the best interests of the corporation through an examination and analysis of the cases in Australia, Great Britain, and New Zealand that gave rise to the duty-shifting doctrine, which Justice Greenberg extended to Canada.[72] Thus, the duty-shifting doctrine acknowledges that, in an insolvency or vicinity of insolvency situation, the interests of the corporation may be equated with the interests of creditors.[73] In other words, they are synonymous, thereby giving rise to the creditors being the residual beneficiaries of the corporation. Endeavouring to maximize corporate value for them achieves "the greatest good for the greatest number".

Stéphane Rousseau also makes the point that the duty-shifting doctrine arises from an examination of a director's duty to the corporation and not from a duty to third parties. After examining the decisions of the trial judge and Quebec Court of Appeal in *People's*, Rousseau writes that,

> It is worth emphasizing that the duty of directors not to disregard creditors' interests remains a duty owed to the corporation. The fact that the duty is "mediated" through the company implies that the enforcement of the duty belongs to the corporation or a plaintiff acting through a derivative action. Creditors who will want to enforce the duty of directors will need to satisfy the conditions of the derivative action, which purports to control opportunistic litigation by creditors...by restricting access to

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[71] Brian Morgan and Harry Underwood, "Directors Liability To Creditors On a Corporation's Insolvency In Light of Dylex and People's Department Stores Litigation" (2003), 39 Can. Bus. L.J. 336.

[72] *Ibid.* at 340-350.

[73] *Ibid.* at 350.

> derivative actions, courts ensure that creditors "cannot inappropriately use corporate resources to pursue litigation".[74]

It is worth noting that, while the Supreme Court of Canada in *People's* did not go so far as to say that, in an insolvency or deteriorating financial situation, a director's duty to act in the best interests of the corporation is to be equated with a duty to act in the best interests of the creditors, the court did concede the ever-increasing importance of the interests of creditors to be considered by directors when acting in the best interests of the corporation in an insolvency or worsening financial situation. The Supreme Court recognized, as a matter of principle, the rising importance of the interests of creditors in an insolvency or situation of financial deterioration by writing that,

> Short of bankruptcy, as the corporation approaches what has been described as the "vicinity of insolvency", the residual claims of shareholders will be nearly exhausted. While shareholders might well 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 might prefer that the directors steer a safer course so as to maximize the value of their claims against the assets of the corporation...
>
> The fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to [a court deciding whether to grant standing to a creditor to pursue an oppression remedy claim against directors].[75]

The underlying rationale of the shareholder and creditor primacy models is maximization of corporate value for the corporate residual beneficiary class in good and distressed financial times. This approach benefits the most number of classes of

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[74] Stéphane Rousseau, "The Duties of Directors of Financially Disturbed Corporations – A Quebec Perspective on the People's Case" (2003), 39 Can. Bus. L.J. 368.

[75] *SCC People's*, *supra* note 16 at paras. 44, 45, and 49.

economic interests in the corporation and generates economic activity. Is the pluralistic corporate decision-making model just as well-suited, or perhaps better-suited, for promoting economic activity for the general benefit of society in good and distressed financial times?

It is arguable that the Supreme Court of Canada's pluralistic decision-making model, requiring directors to ascertain the interests of stakeholders so as to treat them fairly and equitably in the decision-making process, is not as effective in maximizing corporate value. First, unlike the shareholder and creditor primacy models, the pluralistic decision-making model qualifies the pursuit of maximization of corporate value by making it conditional on treating fairly all affected stakeholder interests. Second, this qualification gives rise to uncertainty in the mandate that the pluralistic decision-making model sets for directors. It is an easier task for directors to understand and implement a maximization of corporate value goal as opposed to a maximization of corporate value goal qualified by the requirement to consider and treat fairly all affected stakeholders without any direction as to how to rank these interests in terms of priority. Third, such a lack of clarity and certainty increases the risk of personal liability of directors to stakeholders. This undermines the separate legal personality principle of company law, providing that corporations are separate legal entities, and the related limited liability principle of company law, providing that there is no recourse for claims against a corporation beyond the value of its assets. The effect of these two principles is to provide protection for directors from personal liability for corporate acts. The maximization-of-corporate-value principle relies on these principles. The undermining affects of the

pluralistic decision making model on these concepts of separate legal person, limited liability and protection from personal liability are explored below.

The pluralistic corporate decision-making model, which was created by the Supreme Court of Canada in *People's* and *BCE*, requires directors to focus on a plurality of interests to be canvassed and to be treated fairly and equitably in creating a "better corporation"[76] or in directing the corporation to act as a "good corporate citizen".[77] Having to consider and balance a plurality of interests creates a broader and complicated, and thus less focused, mandate for directors to discharge as compared to a single purpose maximization-of-corporate-value mandate.

Further, defining the mandate of directors as being to create a "better corporation" or to direct the corporation to act as a "good corporate citizen" is to create a decision-making model that is inherently ambiguous and uncertain. Such phrases lack practical meaning to business people, which is what directors are. To the contrary, a business person is more likely to understand what it means to act so as to maximize corporate value under all circumstances. This uncertainty resulting from the pluralistic model is concerning, as it is when a corporation is experiencing financial distress or is insolvent that stakeholder interests conflict and directors are most in need of clear guidance as to their mandate. A maximization of corporate value mandate is easier to understand and

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[76] *Ibid.* at para. 41 wherein the Supreme Court adopted as a correct statement of law Justice Farley's position set out in *820099 Ontario Inc. v. Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 123 (Ont. Gen. Div.) aff'd (1991), 3 B.L.R. (2d) 113 (Ont. Div. Ct.), at 171, that directors and officers in resolving conflicts between stakeholders are to act to make the corporation a "better corporation".

[77] See *BCE*, *supra* note 14 at para. 81 wherein the Supreme Court concluded that where directors are faced with conflicting interests that involve the interests of the corporation then "it falls to the directors of the corporation to resolve them in accordance with their duty to act in the best interests of the corporation, viewed as a good corporate citizen".

implement by directors than is one requiring the measuring and balancing of a plurality of interests in a situation of financial distress or insolvency.

Under the corporate pluralistic decision-making model in Canada, directors are accountable to a plurality of interests. The model is more complicated and less well-defined than the shareholder primacy model. These factors result in greater uncertainty as to a director's mandate or objectives in situations of financial distress or insolvency. Uncertainty increases the risk of personal liability. It allows greater room for interpretation as to how a director should act. This means more challenges and objections to decisions that are made by directors. It also may result in a director believing that certain conduct will not attract liability when it will. As Janis Sarra writes, "[p]arties need certainty in assessing liability for their conduct [and] [t]his is particularly the case with thinly capitalized corporations where third parties are looking beyond the corporate veil to satisfy their claims".[78] Sarra also notes that qualified independent directors may be reluctant to act in larger companies unless the scope of their liability is relatively clear.[79]

The increased risk of personal liability on directors under the pluralistic decision-making model undermines the separate legal personality and limited liability principle of company law. By virtue of statutory incorporation, companies are given attributes of legal personality, meaning that they have the legal powers and obligations of a natural person to hold property, make contracts, sue and be sued in their own name, and

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[78] Sarra, "The Corporate Veil ", *supra* note 60 at 56.

[79] *Ibid.* at 68.

perpetual succession.[80] The separate legal personality principle, in turn, gives rise to the concept of limited liability, meaning that, because the corporation is a separate legal entity, only the corporation will be liable for its wrongful conduct and such liability will be limited by the extent of its assets.[81] Limited liability, as it originated, applied only to shareholders,[82] but the concept was expanded to include employees, directors, and officers and it is common to refer to the limited liability concept as giving rise to a "corporate veil" beyond which the individuals who decided the wrongful corporate conduct, usually the directors, will have no personal liability.[83]

Goddard[84] reviews the separate legal personality and limited liability concepts emanating from *Salomon v. Salomon*[85] and notes the "extensive academic literature on the economic rationale for separate legal personality and limited liability".[86] He explains that the practical importance of these doctrines is three-fold. In summary:

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[80] *Ibid.* at 55.

[81] *Ibid.* at 56.

[82] Christopher C. Nicholls, "Liability of Corporate Officers and Directors to Third Parties" (2001), 35 Can. Bus. L.J. 1 at 2 [Nicholls, "Liability of Corporate Officers"].

[83] Sarra, *supra* note 60 at 56.

[84] Goddard, "Corporate Personality", *supra* note 62.

[85] The first judicial pronouncement of the limited liability principle arising from a registered company is often cited to be the 1897 decision of the House of Lords in *Salomon*, *supra* note 7. That case dealt with "one man companies" or incorporated sole proprietorships. The House of Lords held that the shareholder of Aaron Salomon & Company Ltd. had no personal liability to its creditors.

[86] Goddard, "Corporate Personality", *supra* note 62 at 18 and fn. 16, wherein Goddard cites F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) as a "convenient summary" of the economic rationale for the separate legal personality and limited liability principles upon which company law is founded.

(a) to enable capital for a business venture to be collected from a number of investors over time, while avoiding the costs of transfer of the business's assets when new investors are admitted or existing ones depart;

(b) to reduce the cost of transferring the business's undertaking by transferring the shares thereof rather than the underlying assets; and,

(c) to enable the business venture to be conducted on a limited recourse basis as the default model.[87]

Goddard notes that the first two above-noted factors produce obvious reductions in transaction costs, but what is "less immediately obvious [is] why a default rule providing for limited recourse is a desirable legal rule, producing social gains".[88] Goddard sets out three arguments in favour of limited recourse as the default rule. They may be paraphrased as follows.

(a) Incorporation, giving rise to separate legal personality and liability limited to the extent of a corporation's assets, is the most economically efficient form of business model. Separate legal personality and limited liability arise by default upon the decision to incorporate a business. The market, therefore, is in the best position to dictate which arrangement, or structure, for carrying on business is the most efficient one. The predominance of the corporate form as a business vehicle, with the market thereafter

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[87] Goddard, *ibid.* at 18.

[88] *Ibid.* at 18-19.

determining to what extent the default rule is to be varied, is evidence that the default rule is considered to be the most economically efficient one.[89]

(b) It is a red herring to complain that the protection from personal liability for corporate acts, that flows from the concepts of separate legal person and limited liability, is harmful to voluntary creditors and, thus, is not a justifiable legal concept. Voluntary creditors, who can adjust contract terms for credit risk, have no greater complaint for not being able to collect from a corporation than they do from an individual. The risk of non-payment in our free market system is inherent in every transaction that involves extending credit or loaning money – business is all about managing risk and "*Salomon* is clearly right [because] [t]he company's creditors knew they were dealing with a limited company".[90] Nonetheless, Goddard makes an exception where a creditor is deliberately or carelessly misled as to the creditworthiness of the corporation and the information that was withheld would have been material to the creditor's decision to extend credit or loan money. He makes another exception for situations in which the creditworthiness of the corporation changes after the initial agreement to extend credit or loan money to the corporation and the creditor is unaware of this change. In this situation, he argues that directors who know that a company cannot pay for goods or services that

[89] *Ibid.* at 23.

[90] *Ibid.* at 23 and 27. Goddard does not believe that voluntary creditors should have no recourse against directors. At 30–32, he says that he would allow such personal recourse in all instances of fraud, misrepresentation, and deception, including where creditors are misled, including by silence, when a corporation cannot meet its obligations as they come due yet continues to trade.

are obtained on credit, or for loans advanced, are "practicing a deception on those creditors".[91]

(c) Protection from personal liability reduces monitoring costs, in the sense that, since shareholders do not have personal liability, they do not need to micromanage the conduct of the corporation to make sure that its debts get paid, and it makes securities markets possible by basing the determination of share prices on the value of the corporation and not the net worth of the selling shareholder. If shareholders were to be liable for corporate debts, then a shareholder's ability to pay for such corporate debt, or a shareholder's net worth, would need to be factored into the determination of share value. This would complicate the valuation of shares and the same shares in a corporation would differ in value because the net worth of each selling shareholder might be different.[92]

The separate legal person and limited liability concepts, resulting in protection from personal liability for directors as well as shareholders, also give rise to another social benefit by creating an environment whereby directors feel safe in taking business risks with a view to maximizing corporate value and, thus, stimulating socially beneficial economic activity. As Goddard points out, "[b]usiness people do not seek to eliminate risk – quite the reverse. They actively seek to take certain risks, and to find the most

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[91] *Ibid.* at 30-31.

[92] *Ibid.* at 23-24.

appropriate way to manage other risks which result from business decisions.[93]" This may be referred to as entrepreneurial risk, which is to be encouraged.

Decreasing the protection that is afforded to directors from personal liability, under basic corporate law concepts, is inconsistent with maintaining an atmosphere that promotes directors taking business risks with a view to maximizing corporate value and, thereby, stimulating economic activity. As Jassmine A. Girgis[94] explains, increased risk of personal liability may lead to over-deterrence on the part of directors, or, put another way, directors may proceed in too cautious and conservative a manner, thereby missing legitimate business opportunities. This is especially critical in a deteriorating financial situation or insolvency, as directors may decide against, or simply fail to appreciate, reasonable measures that might be implemented with a view to turning around the corporation's failing financial situation and bringing it back to profitability for the benefit of all, or at least the majority of, stakeholders.[95]

Increased risk of personal exposure also may result in directors resigning, corporations not being able to attract qualified directors, and directors acting precipitously to assign the company into bankruptcy or file for bankruptcy protection. The bankruptcy options would afford protection to the directors under bankruptcy

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[93] *Ibid.* at 22.

[94] Jassmine Girgis, "Deepening Insolvency In Canada?" (2008), 63 McGill L.J. 167.

[95] *Ibid.* at 181. See also Jason Harris, "Relief From Liability For Company Directors: Recent Developments and Their Implications" UWS Law Review [forthcoming in 2009 available at SSRN: <http://ssrn.com/abstract=1399191>] [Harris, "Relief"], wherein it is noted that the Commonwealth Treasury of Australia is reviewing whether state regulation imposes too high of a risk of personal liability on directors and the author, at 17, recognizes that "too much regulation may institute excessive sanctions that drive corporate managers and directors to be overly cautious and conservative which could lower economic performance, harm the economy, and lower national living standards".

legislation, but if exercised prematurely, would result in the corporation being put out of business, or a costly bankruptcy restructuring taking place, without adequate consideration first being given to measures that might have been taken to turn around the corporation without resorting to bankruptcy laws.[96]

Some argue that the legal principle that a corporation is a separate legal entity with limited liability, and thus its directing minds are immunized from personal liability for corporate acts, may be so porous that it is no longer a meaningful theory of company law. Jason Neyers[97] reviews the principle that a corporation is a separate legal entity with limited liability and arrives at this conclusion. Neyers argues that Canadian company law is incoherent because it is centered on a separate legal entity doctrine that is disregarded and pierced so often that a corporation cannot both be and not be a separate legal person. He adds that it also is incoherent because it does not explain who or what a legal corporation is, making it virtually impossible for directors to figure out what it means to act in the best interests of the corporation.[98]

Coherent or not, what is important about the doctrine of separate legal entity and limited liability, and what is worth saving, is one of the basic results that flows from these

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[96] I have practiced in the area of bankruptcy and insolvency since 1991. Based on this experience, it is evident to me that invoking bankruptcy legislation to liquidate or restructure adds an additional layer of professional costs to the situation. These costs are borne by the corporation and its stakeholders. Economic efficiency dictates avoiding these costs if possible.

[97] Neyers, "Canadian Corporate Law", *supra* note 45.

[98] *Ibid.* Neyers offers an alternative or replacement principle for the foundation of company law rather than the separate legal entity doctrine. He proposes a private law model that acknowledges that a corporation is a nexus of jural relationships between players – i.e., between shareholders, shareholders and directors whereby directors make a promise to the shareholders to manage the corporation's patrimony with care and loyalty so as to maximize its net present value, and directors as agents of the corporation and outside entities with an interest in what the corporation does, whereby, for example, creditors agree to limit their execution for default or breach against the assets of the corporation.

doctrines. It is that directors are not liable for corporate acts. Directors need protection from exposure to personal liability so that they may feel and be safe in taking business risks with a view to maximizing corporate value and, thus, stimulating socially beneficial economic activity. Thus, the overriding consideration should be to give directors sufficient protection from personal liability in order to allow them to make the necessary decisions and take the necessary risks, with a view to maximizing corporate value for the benefit of all stakeholders. To fit this principle within the nexus of a jural-relations theory of company law, we could say that there is an understanding among directors and all stakeholders that the directors will govern with a view to maximizing corporate value for the general benefit of all stakeholders without personal liability.

(d) Do Sufficient Governmental Controls Exist to Address Socially Undesirable Consequences of Maximization of Corporate Value?

To recap, a strong argument can be made that maximization of corporate value is generally in the best interests of the corporation and of all, or at least most, of the stakeholders and that the shareholder and creditor primacy models are better designed to achieve this objective. Nonetheless, it is also generally accepted by proponents of the shareholder and creditor primacy models that maximization of corporate value, as a desirable social policy, has its limits, as it may have consequences or give rise to behaviour that is deemed not to be socially acceptable. As such, the legislatures have stepped in to create an extensive network of rules and regulations with the intention of promoting and protecting stakeholder interests and social welfare in general. Is this government intervention sufficient to protect the stakeholder interests as contemplated by the Supreme Court of Canada in *People's* – i.e., shareholders, employees, suppliers,

creditors, consumers, the government, and the environment – or was displacing the incumbent maximization-of-corporate-value decision-making model with a more pluralistic one warranted? This question can only be answered by taking into consideration the existing regulatory framework for protecting stakeholder interests.

It has been estimated that, in Canada, there may be as many as 200 federal and provincial statutes imposing potential personal liability on directors with the aim of influencing their behaviour.[99] Legislation for the purpose of imposing liability on directors to influence their behaviour is not unique to Canada. In the United States and in the English-speaking Commonwealth countries, there are extensive statutory regimes imposing personal liability on directors with an eye to influencing their behaviour to achieve socially desirable norms. In Australia, a government review is underway to examine the appropriateness of current levels of statutory personal liability on directors. The concern is that "too much regulation may institute excessive sanctions that drive corporate managers and directors to be overly cautious and conservative which could lower economic performance, harm the economy and lower national living standards.[100]"

A similar concern seems to be emerging in Canada at the level of the federal government. The Parliamentary Information and Research Service of the Library of Parliament, in its 2008 report entitled "Directors' Liability Under the *Canada Business*

[99] Steven Donley and Nigel Kent, "Directors and Officers Liability in Canada: A Review of Exposures and Coverages Available Under D&O Policies" (June 2008), online: Clark Wilson LLP http://www.cwilson.com at 9 and fn 74 [Donley and Kent, "Directors"], citing Marsh Canada Limited (December 2006) "Directors and Officers Liability", publication no. B061112 (C06120STE): 2006/12/13.

[100] Harris, "Relief", *supra* note 95 at 17.

Corporations Act",[101] acknowledges that "[c]hanging the law to make directors personally liable is a relatively simple way to influence corporate behavior" with a view to achieving objectives that are considered to be socially desirable, like "regulations designed to protect the environment, for example". However, it cautions against the risk of too much personal liability creating an imbalance between two important public policy objectives, being protecting stakeholder interests that are deemed to be worthy of protection and promoting economic activity.[102]

The risk is that too much personal liability in the equation expands "the class of stakeholders to whom a duty is owed" and, thus, "may alter the traditional motivation of corporations, that of maximizing shareholder values" and it may make Canadian corporations less competitive and efficient. The negative effect on a corporation's competitiveness and efficiency would be the result of:

(a) increased compliance costs, as directors will incur costs for professional fees for advice on corporate governance and for errors and omissions insurance to protect themselves from personal liability;

(b) indecision resulting from fear of being sued personally; and

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[101] Library of Parliament, *Directors' Liability Under the Canada Business Corporations Act* by Andrew Kitching (Ottawa: Parliamentary Information and Research Service PRB 08-25E October 16, 2008). The Parliamentary Information and Research Service of the Library of Parliament is a support service for Parliament. Its analysts conduct research and provide information to Committees and Members of the Senate and House of Commons on issues or matters that are deemed to be of national interest. This service is provided on a without partisan basis.

[102] *Ibid.* at 2-3.

(c) an inability to attract qualified individuals to act as directors.[103]

The report concludes by pointing out that the balance between achieving good corporate governance through personal liability and promotion of economic activity is a national issue that is being monitored, given the expansion over the past decade of personal liability both by statute and the judiciary, and that:

> [t]he imposition of ever-increasing personal liability on directors may eventually affect the management and business efficiency of Canadian corporations. If that is the case, amendments to the *CBCA* that place limits on the personal liability of directors may become necessary.[104]

There is a high degree of uniformity between the federal and provincial statutes that have been enacted to protect stakeholder interests in Canada.[105] It is not within the scope of this paper to conduct a detailed analytical review of the federal and provincial statutory provisions that impose personal liability on directors and the jurisprudence emanating thereunder. For the purpose of this paper, what is important is simply that there does exist an extensive regulatory network that requires directors, under the threat of personal liability, to consider and protect all of the stakeholder interests that are listed by the Supreme Court of Canada in *People's* and reiterated in *BCE*.[106] What is significant about this is that the court did not consider this extensive regulatory network in deciding

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[103] *Ibid.*

[104] *Ibid.* at 5.

[105] Donley and Kent, "Directors", *supra* note 99 at 1.

[106] An attempt is made to list all federal statutory provisions imposing personal liability on directors in Donley and Kent, *ibid.* These authors, at p. 6, also note that securities regulation is a matter of provincial jurisdiction and that Ontario, by way of its *Securities Act*, R.S.O. 1990, c. S.5, as amended, plays the lead role in securities regulation as it has the largest and most active capital markets. The authors also note that other provinces seem to be following Ontario's lead in adopting similar securities legislation.

whether it was necessary to dilute the maximization of corporate value principle to provide for more protection of stakeholder interests by displacing the incumbent shareholder primacy model with a more pluralistic one. The existence of this extensive regulatory framework may be found in the comprehensive practical guides and reference materials on directors' liabilities that are published by all major Canadian law firms. The purpose of these materials is to educate directors about which stakeholder interests they need to protect in the corporate decision-making process in order to avoid the risk of personal statutory liability.[107]

For example, Torys LLP[108] and Osler LLP[109] publish practical comprehensive guides for directors, listing and examining the statutory provisions that expose directors to risk of personal liability in order to influence their behaviour. These two practical guides are consistent in the statutory liabilities that they list and explain in order to educate directors as to which stakeholder interests must be protected to avoid personal liability. In the Osler LLP guide, the stakeholder interests that directors are taught to

[107] I undertook a review of the internet websites of seven major Canadian law firms to determine the extent of publications addressing the nature and scope of personal liability for directors. These seven law firms were: Blakes, Davies, Goodmans, McCarthy, Osler, Stikeman, and Torys. These firms were chosen as they are commonly referred to as the "seven sisters" of Canadian law firms. This is a moniker that was given to these firms in a 2003 article in a law magazine known as Lexpert, which promotes itself as "Canada's leading source of news and information about the business of law" online: Lexpert.ca <http://www.lexpert.ca>. Lexpert gave the firms this nickname because they were identified as the top-ranking law firms in Canada based on their involvement in the biggest corporate transactions for 2002. All of their internet websites contained materials for the purpose of educating directors as to the nature and scope of their personal liability in the form of updates, bulletins, and reference manuals.

[108] Scott Bomhof, *Duties of Directors in the Insolvency Zone*, (October 2009), online: Torys.com <http//www.torys.com/Publications/Documents/Publication%20PDFs/AR2009-51.pdf>.

[109] The most comprehensive publication from among the seven major Canadian law firms referred to above appears to be the reference guide that is published by Osler. See Shelley Obal, ed., *Corporate Governance in Canada: A Guide to the Responsibilities of Corporate Directors in Canada,* 5th ed. (March 2009), online: Osler.com <http://www.osler.com/resources.aspx?id=8115>.

protect in their decision-making in order to avoid personal liability may be paraphrased as follows.

(a) The reasonable expectations of, among others, shareholders and creditors as "complainants" under the oppression remedy. It is to be noted that creditors include lenders and suppliers and generally anyone to whom the corporation owes money. It is also worthy to note that the class is broadened by the inclusion of contingent creditors. Any stakeholder with a claim for monetary loss or damages against the corporation that has either not yet crystallized or is still subject to proof of liability and quantification and with a reasonable expectation that assets of the corporation will be available to satisfy any judgment granted is a contingent creditor. An example of such a contingent creditor would be an employee with a wrongful dismissal claim.[110]

(b) The interests of, among others, shareholders and creditors, when they are synonymous with the interests of the corporation. In this regard, shareholders and creditors, including contingent creditors, may be granted leave of the court, if they qualify as "complainant" to commence an action against a director on behalf of the corporation if the director has committed an actionable wrong against the corporation and that wrong resulted in the corporation suffering loss or damages, which in turn prejudices their interest in the corporation. For example, if a director has

[110] *Ibid.* at 15. See fn. 161 below.

breached his or her fiduciary duty or duty of care to the corporation and the corporation has suffered a loss, thereby adversely affecting share values or the corporation's ability to pay creditors, then, by derivative action, those stakeholders may recover for the corporation its loss, which, in turn, would allow the corporation to honour its commitments to them.[111]

(c) The interests of any third party in having the corporation abide by its articles, by-laws, or unanimous shareholders agreement. This is done by way of a compliance order.[112]

(d) The interests of the existing shareholders in maintaining the value of their shares by prohibiting the issuance of shares for property or past services that have a fair market value that is less than the money that the corporation would have received if it had issued the shares for money.[113]

(e) The interests of creditors, such as lenders and suppliers, in not having the assets of the corporation depleted by the purchase, redemption, retraction, or other acquisition of shares, the payment of a dividend on shares, the provision of financial assistance to certain related parties, or the payment to a shareholder who has exercised statutory dissent rights, where to do so would contravene the statutory insolvency tests. These tests are where the corporation is, or would be after the payment in question, unable to pay its

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[111] *Ibid.* at 16.

[112] *Ibid.* at 17.

[113] *Ibid.* at 66.

liabilities generally as they come due or the reasonable value of its assets would be less than the aggregate of its liabilities and stated capital of all classes of shares.[114]

(f) The interests of investors, and the economy for the benefit of the public in general, in having fair and transparent capital markets by: (i) prohibiting insider trading, meaning that persons who have information about a corporation that might affect stock prices should not use that information to trade in securities of the corporation or to assist others in trading in such securities before the information becomes public; and, (ii) requiring a certain amount of disclosure to be made to investors who are looking to purchase corporate stock and prohibiting market manipulation, fraud, and certain other misconduct as set out in securities legislation. It is worth noting that securities regulation is a matter of provincial jurisdiction and that Ontario, by way of its *Securities Act*, plays the lead role as it has the largest and most active capital markets, and other provinces seem to be following Ontario's lead in adopting similar securities legislation.[115]

(g) The interests of shareholders to be advised of and to be given the opportunity to vote at a meeting of the shareholders and to be made aware of material facts affecting the corporation, by making it an offence to fail to deliver a proxy to shareholders at the time that they are given notice of

[114] *Ibid.* at 66-68.

[115] *Ibid.* at 69-71, in respect of insider trading, and 46-53, in respect of securities regulation. In respect of securities regulation, see also Donley and Kent, *supra* note 99 at 6-9. See also *Securities Act*, R.S.O. 1990, c. S.5, as amended.

a meeting of shareholders, to fail to send a management proxy circular before soliciting proxies, and to include an untrue statement of material fact in certain documents, such as a management proxy circular, or the omission of a material fact in such a document.[116]

(h) The interests of the public in preventing harm to the environment. There are federal and provincial statutes imposing potential liability on directors who do not take reasonable care to ensure that the corporation complies with environmental legislation and where a director has some involvement in environmental damage that is suffered. There are also related statutes protecting, by way of personal liability, specific environmental harms, such as the harmful alteration or destruction of fish habitats.[117]

(i) The interests of employees in their pensions. Under pension benefits legislation, directors may be guilty of offences if they authorize or participate in a failure by the corporation to remit amounts that are owing to the pension fund.[118]

(j) The interests of employees in being paid their wages and vacation pay and, in the case of corporations under federal jurisdiction, termination and severance pay if certain conditions are met.[119]

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[116] Obal, ed., *ibid.* at 71.

[117] *Ibid.* at 71-73. See also Donley and Kent, “Directors”, *supra* note 99 at Appendix A.

[118] Donley and Kent, *ibid.* See also Obal, ed., *ibid.* at 73-74.

[119] Obal, ed., *ibid.* at 74-75.

(k) The health and safety of employees on the work-site pursuant to health and safety regulations.[120] and,

(l) The public interest in collection of taxes to fund government programs. Directors may be liable for the corporation's failure to remit to Canada Revenue Agency employee payroll deductions for personal income tax that is payable by the employee, the employee's unemployment insurance and Canada Pension Plan premiums, and any unpaid Goods and Services Tax and, in respect of the provinces, any unpaid retail sales tax that is collected by the corporation.[121]

The following additional protections are afforded to consumers and the public in general by way of personal liability on directors:

(a) for deceptive marketing practices or improper packaging and label practices;[122]

(b) for advertising, selling, or importing a prohibited product;[123] and,

(c) for failing to properly handle dangerous goods.[124]

Although not forming part of the analysis in this thesis, in addition to regulatory protection, stakeholders also are afforded protection by way of personal liability against

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[120] *Ibid.* at 76.

[121] *Ibid.* at 76-78.

[122] Donley and Kent, "Directors", *supra* note 99 at Appendix A.

[123] *Ibid.*

[124] *Ibid.*

directors at common law and in equity under doctrines such as negligent and fraudulent misrepresentation, fraud, and deceit, and the principles that govern when a corporation's veil should be pierced. Thus, given the protection that is afforded to stakeholders under a comprehensive regulatory regime, supplemented by common law and equity, it is arguable that the rejection of the traditional shareholder primacy model in favour of a pluralistic one, and thus the deviation from the maximization of corporate value principle, was not warranted.

(D) Summary

This chapter reviewed the conceptual and pragmatic arguments in the academic debate between shareholder primacy and pluralism, as corporate decision-making models. The conceptual debate does not produce a clear winner. Thus, I undertook a pragmatic comparison of the effects of each model with a view to ascertaining whether one model was preferable over the other based on pragmatic considerations. The conclusion of this chapter is that the pragmatic residual-claimants argument resolves the debate in favour of the shareholder and creditor primacy models. This is because the residual-claimants argument is based on the maximization-of-corporate-value principle, and this principle is worthy of protection and promotion because of its more certain focus on stimulating economic activity for the benefit of society as a whole under all circumstances or, at a minimum, preserving economic value for as many classes of economic interests as possible – i.e., "greatest good for the greatest number". However, this is not an absolute principle. It co-exists with an extensive state-imposed pluralistic regulatory regime, supplemented by common law and equity, making it unnecessary to

displace the maximization-of-corporate-value model with a more ambiguous pluralistic one.

CHAPTER 4

DELAWARE CORPORATE LAW

We have seen how the question of what it means for directors to act in the best interests of the corporation has spawned a debate between two competing corporate decision making models, being the shareholder primacy model and the pluralistic model. We have seen how the shareholder primacy model was the generally accepted corporate decision-making model in Canada prior to the Supreme Court of Canada in *People's* adopting a pluralistic decision-making model. Moreover, the shareholder primacy model, with a shift to a creditor primacy model upon financial distress or insolvency, is the accepted model in the United Kingdom, Australia, and New Zealand. This chapter examines how Delaware treats the question of what it means for directors to act in the best interests of the corporation.

Delaware is widely recognized as having one of the most advanced and flexible business formation statutes in the United States. Furthermore, Delaware has a long-serving specialized court, known as the Court of Chancery, for dealing with corporate law matters. Both of these factors draw to Delaware people that are looking to incorporate. The volume of business incorporations invariably gives rise to an increased number of corporate law disputes upon which the specialized Court of Chancery and the Supreme Court, on appeal, adjudicate. This has resulted in a significant amount of

corporate law jurisprudence and the Delaware courts being widely recognized as a leading authority on corporate law.[125]

The shareholder primacy model, shifting to a creditor primacy model in circumstances of financial distress or insolvency, and the pluralistic decision-making model have been described and explained in previous chapters. For ease of reference, they may be summarized as follows.

(a) The shareholder primacy model equates directors acting in the best interests of the corporation with the economic interests of the residual risk-bearers. Under this model, the primary duty of directors is to strive to maximize corporate value from the perspective of the shareholders, except in cases of financial distress or insolvency where it appears that the shareholders have lost their investments. When it appears that the shareholders have lost their investments, the creditors replace the shareholders as the residual risk-bearers and directors are required to act to maximize or preserve corporate value for them, so as to protect their remaining economic investment.

(b) The pluralistic model equates directors acting in the best interests of the corporation with making a decision that considers and balances the interests of all affected stakeholders. In other words, directors are to focus on making a decision that is considered fair and reasonable in the circumstances, given its impact on all

[125] See online: State of Delaware <http://www.corp.delaware.gov> and Delaware State Courts <http://www.courts.delaware.gov/Courts/Court%20of%20Chancery/>. Also, the Delaware courts are described in Rotman, *supra* note 6 at 30, as being "readily acknowledged as the primary source of domestic corporate law" in the United States.

affected stakeholders with an economic or social interest in the corporation, and not a decision that is automatically driven by maximizing corporate value.

Like the Supreme Court of Canada in *People's* and *BCE*, the Delaware courts have considered what it means for directors to act in the best interests of the corporation in the context of creditors complaining about the decisions of directors that are made in a vicinity of insolvency[126] or an insolvency situation and in corporate takeover scenarios. Two leading Delaware decisions were made in the context of creditors complaining about decisions of directors that were made in insolvency of vicinity of insolvency situations. They are the decision of the Court of Chancery in *Production Resources Group, L.L.C. v. NCT Group Inc.,*[127] followed by the decision of the Delaware Supreme Court in *North American Catholic Educational Programming Foundation Inc. v. Rob Gheewalla, Gerry Cardinale and Jack Daly,*[128] affirming the decision of the Court of Chancery at first instance. A number of watershed decisions in Delaware have considered the role of directors and what it means to act in the best interests of the corporation in a corporate takeover scenario. These are the decisions of the Delaware Supreme Court in the "*Revlon* line [of cases]".[129]

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[126] The Delaware courts use the phrase "zone of insolvency", whereas the Supreme Court of Canada refers to this state of affairs as the "vicinity of insolvency". This state of affairs also is referred to as "near insolvency" or the "twilight zone". It is more fully addressed in the next chapter. The Foreword and Acknowledgement of *Directors in the Twilight Zone II* (London: INSOL International, 2005) defines this state of affairs as being when a company runs into financial difficulty and the directors are not sure whether a formal insolvency will follow.

[127] *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004) [*Production Resources*].

[128] *North American Catholic, supra* note 29.

[129] This is how the Supreme Court of Canada in *BCE Inc., supra* note 14 at para. 86 referred to the two cases of *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. Sup. Ct. 1985) [*Revlon*] and *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. Sup. Ct. 1985) [*Unocal*].

As we have seen, the Supreme Court of Canada rejected the traditional shareholder and creditor primacy model, with its primary focus on achieving maximization of corporate value, in the leading cases of *People's* and *BCE*. In contrast, the Delaware Court of Chancery and Supreme Court have continued to emphasize that the primary duty of directors in acting in the best interests of the corporation is to strive to maximize corporate value.

Production Resources was a decision of the Court of Chancery.[130] Production Resources was both a plaintiff and a judgment creditor of the corporate defendant NCT, which owed it $2 million. Production Resources was thwarted in its attempt to collect its judgment debt. In this regard, it issued a complaint against the directors and the chief financial officer of NCT for breach of fiduciary duty. The claim that the defendants breached their fiduciary duties through generalized mismanagement was dismissed on the basis that it was not supported by the facts that had been pleaded. However, the breach of fiduciary duty claim was allowed to stand. The breach of fiduciary duty claim was based on the allegation that the directors and chief financial officer of an insolvent NCT had acted improperly in arranging financing terms and using the money advanced from NCT's primary secured creditor so as to prejudice the interests of Production Resources as an unsecured judgment creditor. The court reasoned that these actions created "an inference of faithless behaviour".[131] Production Resources alleged:

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[130] The decision resulted from a motion by the defendants to dismiss the plaintiff's complaint for failure to state a claim for which relief could be granted.

[131] *Production Resources, supra* note 127 at 777.

> a suspicious pattern of dealing that raises the legitimate concern that the NCT board is not pursuing the best interests of NCT's creditors as a class with claims on a pool of insufficient assets, but engaging in preferential treatment of the company's primary creditor and de facto controlling shareholder (and perhaps of its top officers, who are also directors) without any legitimate basis for the favouritism.[132]

The Court of Chancery concluded that the complaint alleged sufficient facts to find the directors of NCT in breach of fiduciary duty. The Court of Chancery held that the fiduciary duty was owed, however, to the corporation and not to the creditor. Production Resources had argued that all breach of fiduciary duty claims become direct claims against directors when the corporation enters the zone of insolvency or becomes insolvent. The directors of NCT argued that, at all times, such claims remained derivative and had to be brought on behalf of the corporation for harm suffered by it. In deciding that the fiduciary duty was owed to the corporation, the court noted that "[t]ypically, creditors may not allege fiduciary duty claims against corporate directors".[133] The court added that, in a vicinity of insolvency or insolvency situation, the fiduciary duties of the directors continued to be owed to the corporation but that Delaware law recognized that an insolvency "necessarily affected the constituency on whose behalf the directors" pursued their objective of maximizing the economic value of the corporation.[134] In other words, the Court of Chancery in *Production Resources* endorsed the economic maximization of corporate value rationale behind the shareholder primacy model, which in effect becomes a creditor primacy model as financial distress

[132] *Ibid.* at 800.

[133] *Ibid.* at 787.

[134] *Ibid.* at 790-791.

eliminates the likelihood of providing an economic return to the shareholders on their investments.

The Court of Chancery was not prepared to rule out completely that there might be an exception to the rule that creditors' claims for breach of fiduciary duty are to be brought on behalf of the corporation and not directly against directors. The court contemplated that "there might possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor".[135] This set the stage for the Delaware Supreme Court in *North American Catholic*, on appeal from the Court of Chancery, to confirm that acting in the best interests of the corporation gave rise to a duty on directors, under all circumstances, to work towards maximizing corporate value and that, under all circumstances, the fiduciary duty of directors is owed to the corporation and never to the creditors.[136]

Like *Production Resources*, the decision of the Supreme Court in *North American Catholic* arose from a motion that had been brought by the defendant directors to dismiss a complaint that the plaintiff North American Catholic had brought against them for breach of fiduciary duty. The Supreme Court affirmed the decision of the Court of Chancery granting the motion and dismissing the complaint. The Supreme Court noted that, unlike in *Production Resources,* the plaintiff North American Catholic did not attempt to allege a derivative claim against the directors for breach of fiduciary duty

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[135] *Ibid.* at 798.

[136] *North American Catholic, supra* note 29 at 103 and fn. 43.

while the corporate debtor was in the vicinity of insolvency or insolvent and, thus, its complaint failed as directors did not owe a fiduciary duty to creditors.[137]

The Delaware Supreme Court in *North American Catholic* endorsed the Court of Chancery's viewpoint in *Production Resources* that a director's primary duty in managing the business and affairs of the corporation was to maximize corporate wealth. This is the shareholder primacy model. The Supreme Court concluded,

> When a corporation is *solvent*, [a director's fiduciary duty to the corporation] may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value...
>
> ...The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."[138]

Later in its reasons for judgment, the Delaware Supreme Court noted that if directors were to owe individual creditors a fiduciary duty, then this "would create a conflict between [a director's] duty to maximize the value of the insolvent corporation" and "the newly recognized direct fiduciary duty to individual creditors".[139] This conflict between maximizing corporate wealth and giving priority to the interests of individual creditors was to be avoided by restricting a director's fiduciary duty to the corporation. The Delaware Supreme Court has endorsed clearly a decision-making model that has

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[137] *Ibid.* at 102.

[138] *Ibid.* at 101-102 [emphasis in original]. The Court of Chancery's decision in *Production Resources* was cited as authority for this quote.

[139] *Ibid.* at 103.

maximization of corporate value as its primary focus, being initially synonymous with the economic interests of shareholders with a shift to the economic interests of creditors as the corporation slips into insolvency.

Nonetheless, under Delaware law, there is room, but only the slightest amount of room, for directors to consider the interests of stakeholders other than shareholders and creditors. As the Court of Chancery wrote in *Production Resources*,

> These realities, of course, do not mean that directors are required to put aside any consideration of other constituencies, including creditors, when deciding how to manage the firm. But it does mean that directors – as fiduciaries in equity – are primarily focused on generating economic returns that will exceed what is required to pay the bills in order to deliver a return to the company's shareholders who provided equity capital and agreed to bear the residual risk associated with the firm's operations.[140]

By way of footnote to support the foregoing statement, the Court of Chancery cited the Delaware Supreme Court's decision in *Revlon*[141] as authority for the proposition that "[a] board can consider the interests of other constituencies if they are rationally related to furthering the interests of shareholders".[142]

The Court of Chancery in *Production Resources* made a point of further restricting the role of pluralistic considerations in the law of corporate decision-making by taking the opportunity to interpret narrowly its earlier decision in *Credit Lyonnais*.[143]

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[140] *Production Resources, supra* note 127 at 787.

[141] *Revlon, supra* note 129.

[142] *Production Resources, supra* note 127 at fn. 48.

[143] *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

In *Credit Lyonnais*, the court had to consider a situation in which shareholders claimed that directors had a duty to undertake a risky investment strategy for their benefit when the corporation was in the "zone of insolvency" as long as the corporation did not technically breach legal obligations. In *Credit Lyonnais* the Court of Chancery held that directors did not have such a duty to the shareholders and that they could pursue a less risky course of action where they believed, in good faith, that a riskier investment strategy might render the company unable to meet its legal obligations to creditors and others. In *Production Resources*, the Court of Chancery explained that:

(a) *Credit Lyonnais* meant that directors had an obligation "to preserve, and, if prudently possible, to maximize the corporation's value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action the stockholders might favour as best for them"; and

(b) its decision in *Credit Lyonnais* provided directors with a shield for protection from demands of shareholders to pursue extreme risk at the expense of the corporation's economic well-being and did not provide a sword to creditors or others with which they could attack directors.[144]

Clearly, in *Credit Lyonnais*, the downside risk of putting the company out of business was too great and inconsistent with a director's mandate "to preserve and if prudently possible" to increase corporate wealth. The emphasis and focus under Delaware law is always on achieving an economic return for the shareholder and creditor investors with statutory provisions and regulations, equity, and the common law filling in

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[144] *Production Resources, supra* note 127 at 787-789.

to temper any side effects arising from the pursuit of this goal that are deemed to be socially unacceptable. In other words, the Delaware courts define what it means to act in the best interests of the corporation first and foremost in terms of maximization of corporate value for shareholders and if their investment seems lost, then for creditors.

The Delaware Supreme Court again exhibited this emphasis on maximization of corporate value under Delaware law in its March 2009 decision in *Lyondell Chemical Company v. Ryan.*[145] That case involved director approval of a merger with another chemical company. In *Lyondell*, the court held that it was a proper exercise of a director's business judgment to adopt a "wait and see" approach to the market for the corporation's shares, as opposed to shopping them around, in response to a securities filing by a third party disclosing its right to buy a block of shares, which signalled that the company was "in play" — i.e., up for sale.[146] This course of conduct was ruled a reasonable way to attempt to maximize corporate wealth. The business judgment rule was invoked to protect the manner in which the directors decided to maximize corporate wealth when faced with the threat of a corporate takeover.

Maximization of corporate value for shareholders, shifting to maximization of corporate value for creditors when the investment of the shareholders appears to be lost, is also the approach that is endorsed by the courts in Australia, New Zealand, and the United Kingdom on what it means for directors to act in the best interests of the

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[145] *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. Sup. Ct. 2009).

[146] Scott J. Davis, "United States: Delaware Supreme Court Provides Further Guidance on 'Revlon' Duties and Duty of Good Faith", Case Comment (April 7, 2009), online: Mayer Brown LLP <http://www.mayerbrown.com>.

corporation.[147] As noted in Chapter 3 above, at the trial level in *People's*, Justice Greenberg applied the rationale of these commonwealth courts in adopting the concept of a shareholder primacy model shifting to a creditor primacy model in an insolvency. This was overturned by the Supreme Court of Canada.

The Canadian rejection of the shareholder primacy model, and its offspring the creditor primacy model, in favour of pluralism as the governing decision-making rule is best exemplified by the Supreme Court of Canada's rejection of the "*Revlon* line" of cases in *BCE*.[148] *Revlon* is considered to stand for the proposition that, in a corporate takeover situation where the interests of shareholders conflict with the interests of creditors, the interests of the shareholders should prevail. In *BCE*, the court was called upon to decide whether BCE's directors had acted properly in accepting a leveraged buy-out offer that increased share values but decreased bond values. The Supreme Court of Canada rejected the *Revlon* proposition, by writing that "[t]here is no principle that one set of interests – for example the interests of shareholders – should prevail over another set of interests. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised business judgment in a responsible way."[149]

Clearly, the Supreme Court of Canada did not want to restrict directors in exercising their powers to act primarily with a view to maximizing corporate value. The

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[147] Ziegel, "Creditors as Corporate", *supra* note 65.

[148] *BCE, supra* note 14 at paras. 84-85.

[149] *Ibid.* at para. 84. Ironically, the application of pluralism to the situation at hand in *BCE* resulted in the Supreme Court of Canada upholding the directors' acceptance of the leveraged buy-out offer that favoured shareholders over the creditor bondholders.

Supreme Court of Canada wanted to give directors a broader pluralistic mandate. However, given the lack of an explanation as to why this should be the case, other than to rely on a questionable long-standing Canadian legal principle in support of pluralism being the law in Canada,[150] we are left to question whether there was good reason to deviate from the approach that has been taken by the Delaware courts and other English-speaking common law jurisdictions. These courts agree that a director's primary obligation is to act in the best interests of the corporation. However, the Supreme Court of Canada differs on how to interpret what this means. As the following Chapter explains, it may not have been necessary for the Supreme Court to adopt a pluralistic meaning of what it means to act in the best interests of the corporation given the statutory oppression remedy.

[150] The claim that the Supreme Court of Canada relied on a questionable long-standing Canadian legal principle to support displacing the shareholder primacy model with a pluralistic one is examined in Chapter 6 below.

CHAPTER 5

THE OPPRESSION REMEDY

(A) Introduction

At the time of the Supreme Court of Canada's decision in *People's*, there existed a sufficient amount of pluralism in the decision making process protecting stakeholder interests. This resulted from duties and liabilities imposed on directors by common law, in equity, pursuant to an extensive regulatory network, and by virtue of corporate laws. Included among the relevant corporate statutory provisions was the powerful and flexible oppression remedy. This chapter argues that, insofar as creditors were concerned, being the parties who sought relief in both *People's* and *BCE*, the oppression remedy by itself gave rise to a form of statutory pluralism protecting creditors' interests. The oppression remedy required the reasonable expectations of creditors to be regarded by directors in their decision-making process. This, therefore, made it unnecessary for the Supreme Court of Canada to define acting in the best interests of the corporation in a pluralistic way so as to include creditors.

An oppression remedy provision is contained in the *CBCA*. All provinces, except Prince Edward Island and Quebec, have similar statutory oppression remedy provisions in provincial acts dealing with corporations. The following are the relevant *CBCA* provisions.

> s.241(1) A complainant may apply to a court for an order under this section.
>
> (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.
>
> (3) In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,
>
> ...(j) an order compensating an aggrieved person...[151]

In *People's,* and then in *BCE*, the court acknowledged that the oppression remedy required directors to consider and balance the interests of the shareholders and creditors in issue. However, instead of concluding that therefore it was not necessary to displace the traditional shareholder primacy model with a pluralistic one, the court in *BCE* incorporated principles from the law of oppression to further define the court's pluralistic meaning for acting in the best interests of the corporation. Thus, an examination of the law of oppression is necessary to demonstrate that it gives rise to a pre-existing statutory form of pluralism for shareholders and creditors. This examination will also assist in understanding the nature and scope of the pluralistic definition that was developed by the Supreme Court of Canada for the duty to act in the best interests of the corporation. This is because oppression remedy principles were incorporated into that definition of acting in the best interests of the corporation. An understanding of the meaning as developed by the court for acting in the best interests of the corporation exposes the redundancy in the concept developed by the Supreme Court of Canada.

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[151] *CBCA, supra* note 1 at s. 241(1), (2), and (3) [emphasis added].

(B) Statutory Pluralism

(I) Recognized by the Supreme Court of Canada

In *People's*, the Supreme Court of Canada envisioned an independent role for the law of oppression in regulating the conduct of directors towards creditors in an insolvency or deteriorating financial situation. The court said the following.

> [i]f the stakeholders cannot avail themselves of the statutory fiduciary duty (the duty of loyalty, supra) to sue the directors for failing to take care of their interests, they have other means at their disposal.
>
> The fact that creditors' interests increase in relevancy as the corporation's finances deteriorate is apt to be relevant to, inter alia, the exercise of discretion by a court in granting standing to a party as a "complainant"… to bring an oppression remedy claim...
>
> Section 241 of the *CBCA* provides a possible mechanism for creditors to protect their interests from the prejudicial conduct of directors. In our view, the availability of such a broad oppression remedy undermines any perceived need to extend the fiduciary duty imposed on directors by Section 122(1)(a) of the *CBCA* to include creditors.[152]

In reaching its conclusion that the existence of the oppression remedy was a factor negating any need to equate acting in the best interests of the corporation with the interests of creditors in an insolvency or situation of financial distress, the Supreme Court of Canada cited with approval an essay by David Thomson.[153] In his essay, Thomson theorized that, although Justice Greenberg's trial decision in *People's* (adopting a shifting duty on directors in favour of creditors) marked in Canada an "interesting development in

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[152] *SCC Peoples, supra* note 16 at paras. 47, 49, 50, and 51.

[153] David Thomson, "Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?" (2000), 58 U.T. Fac. L. Rev. 31.

the doctrine of fiduciary duty", the practical effect of this development was redundant "as [the] courts already allow creditors to access the oppression remedy in order to protect themselves from conduct by directors that is prejudicial to or that disregards their interests".[154] Thomson arrived at this conclusion after reviewing the cases giving rise to duty-shifting in Great Britain, New Zealand, and Australia and noted that, in his view, "there [did] not appear to be a qualitative difference between cases argued as a breach of fiduciary duty and oppression cases".[155] In other words, the oppression remedy already influenced directors to consider the interests of creditors and not to oppress, unfairly prejudice, or unfairly disregard these interests in making corporate decisions. A pluralistic definition for what it means to act in the best interests of the corporation was not required to accomplish this protection for creditors.

While the Supreme Court of Canada in *People's* cited Thomson's essay as authority for the proposition that the oppression remedy was available to creditors to protect themselves against directors exercising their powers in such a way as to oppress, unfairly prejudice, or unfairly disregard their interests, the court did not otherwise engage in a more detailed analysis of the law of oppression or, in particular, the application of this law in the context of an insolvency or deteriorating financial situation.

In *BCE*, the Supreme Court of Canada endorsed a two-step approach to deciding oppression remedy claims. The first step is a threshold test. It requires the court to ask itself whether the evidence that has been adduced establishes the reasonable expectation as asserted by the claimant. Upon passing the threshold test, the second step requires a

[154] *Ibid.* at 51.

[155] *Ibid.* at 47.

further review of the evidence to determine whether the reasonable expectation that was found to exist was violated by conduct falling within the terms "oppressive", "unfairly prejudicial", or "unfairly disregard".[156]

With respect to the first branch of the test for deciding oppression remedy claims, the Supreme Court of Canada set out the following factors that are to be considered in determining the existence of reasonable expectations that are to be protected:

> general commercial practice; the nature of the corporation; the relationship between the parties; past practice; steps the claimant could have taken to protect itself; representations and agreements; and the fair resolution of conflicting interests between corporate stakeholders.[157]

These, then, are the factors that are to be applied in determining the reasonable expectations of shareholders and creditors that are to be protected by directors in carrying out their powers. In short, the oppression remedy gives rise to a statutory form of pluralism requiring directors in their decision-making to consider and protect the reasonable expectations of the shareholders and creditors in the circumstances. This would include circumstances of financial distress and insolvency. The existence of a statutory form of pluralism does not support displacing the traditional shareholder primacy model with a pluralistic one. Rather, it demonstrates that adopting a pluralistic definition for acting in the best interests of the corporation was not necessary, and especially ill advised without examining the balance between the traditional shareholder

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[156] *BCE, supra* note 14 at paras. 56 and 68.

[157] *Ibid.* at para. 72.

primacy model and the law arising by virtue of statute, common law, and in equity for protecting the plurality of stakeholder interests.

(II) Defining "Complainant"

To what extent may a shareholder or creditor take advantage of the oppression remedy? Only a "complainant"[158] qualifies to apply for judicial relief under the oppression remedy. A complainant is statutorily defined as a current or former registered holder of a security in a corporation, and security is defined to include a debt obligation, a current or former director or officer, and any other "proper person" in the "discretion of the court".[159] The statute is consistent in making security holders, both in the nature of shareholders and creditors that are registered holders of debt obligations, directors, and officers both complainants and intended victims. However, not all creditors are registered holders of corporate debt obligations, and, therefore, creditors such as trade and judgment creditors are recognized as intended targets of oppression but not necessarily as complainants. They first need to qualify as a "proper person". When will a corporate stakeholder, and in particular a creditor not registered as a holder of a corporate debt obligation, qualify "in the discretion of the court" to be a "proper person" and, thus, a "complainant"?

As stated in *First Edmonton Place*, an applicant will qualify as a complainant

> …if the act or conduct of the directors or management of the corporation which is complained of constituted a breach of the underlying expectations of the applicant arising from the

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[158] *CBCA, supra* note 1 at s. 238.

[159] *Ibid.* at ss. 2.(1) & 238.

> circumstances in which the applicant's relationship with the corporation arose.[160]

A corporate stakeholder will be a complainant in circumstances where it can be said that the corporate stakeholder has a reasonable expectation that the company's affairs will be conducted with a view to protecting its reasonable expectations.[161]

A wrongfully dismissed employee turned judgment creditor was found to be a complainant where a corporate reorganization had the effect of depriving him of collecting on his judgment in *Downtown Eatery (1993) Ltd. v. Ontario.*[162] Justice Hawkin, in *USF Red Star v. 1220103 Ontario Ltd.*,[163] decided that a creditor was not an eligible complainant in circumstances where a creditor had brought an oppression action against a director for unpaid cartage services on the basis that the company was insolvent when it ordered the cartage services and the director was aware of this situation and yet continued to order cartage services knowing that the company would not be able to pay for such services. Justice Hawkin held,

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[160] *First Edmonton Place Ltd. v. 315888 Alberta Ltd.* (1988), 60 Alta. L.R. (2d) 122 (Q.B.) at 152, adj. (1989), 71 Alta. L.R. (2d) 61 (C.A.).

[161] *Downtown Eatery (1993) Ltd. v. Ontario* (2001), 54 O.R. (3d) 161 (C.A.) at paras. 56 and 62 [*Downtown Eatery*]. In *Olympia & York Developments (Trustee of) v. Olympia & York Realty Corp.* (2001), 28 C.B.R. (4th) 294 (Ont. S.C.J.), aff'd (2003), 68 O.R. (3d) 544 (C.A.), Justice Farley, in granting standing as a complainant to a trustee in bankruptcy for the corporation's unsecured creditors, wrote at para. 30:

> While oppression cases should not be used by creditors to facilitate ordinary debt collections, where there is superadded to the equation allegations/facts to support one of the three claims of either (a) "oppression", (b) "unfairly prejudicial" or (c) "unfairly disregards", then creditors have been permitted to be complainants pursuant to s. 245(c) as a "proper person".

[162] *Downtown Eatery, ibid.*

[163] *USF Red Star v. 1220103 Ontario Ltd.* (2001), 13 B.L.R. (3d) 295 (Ont. S.C.J.) [*USF Red Star*].

> …directors of a company may, with impunity, cause the company to order goods and services which they have no objective reason to believe the company can pay for in the absence of a preference or fraudulent activities which impair the company's ability to meet its obligations. As Farley J. said [at page 4 of *Royal Trust Corp. of Canada v. Hordo*, [1993] O.J. No. 1560 (Ont. Gen. Div. Commercial List)], "It does not seem to me that debt actions should be routinely turned into oppression actions."[164]

However, the Supreme Court of Canada cast doubt on the correctness of Justice Hawkin's conclusion by its acknowledgement in *People's* that:

> creditors' interests increase in relevancy as the corporation's finances deteriorate is apt to be relevant to, inter alia, the exercise of discretion by a court in granting standing to a party as a "complainant"… to bring an oppression remedy claim.[165]

Therefore, unsecured creditors have reasonable expectations that directors will not order goods and services in circumstances where it is unlikely that the corporation will be able to pay for such goods and services. Further, such conduct arguably falls outside the scope of risk of non-payment that is assumed by unsecured suppliers in entering into trade relations with the company.

Asset-stripping cases, in which contingent creditors have been given status as complainants (such as in *Downtown Eatery*[166]), cast further doubt on the correctness of Justice Hawkin's conclusion in *USF Red Star*. Justice Pattillo's decision in *Manufacturer's Life Insurance Co. v. AFG Industries*[167] was one such asset-stripping

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[164] *Ibid.* at para. 30.

[165] *SCC Peoples, supra* note 16 at para. 49.

[166] *Downtown Eatery, supra* note 161.

[167] *Manufacturer's Life Insurance Co. v. AFG Industries* (2008), 44 B.L.R. (4th) 277 (Ont. S.C.J.).

case. Justice Pattillo was called upon, among other things, to consider a motion by the parent company defendant to strike an oppression claim that had been brought against it on the basis that the plaintiff could not qualify as a complainant in the circumstances as pleaded. The plaintiff had advanced a claim for recovery of environmental remediation costs against a subsidiary and a claim for an oppression remedy against the parent company on the basis that the parent company had caused the subsidiary to divest itself of all of its assets, thereby precluding recovery of any judgment for environmental damage that was awarded against the subsidiary. Justice Pattillo noted a series of cases in which asset-stripping in the face of a claim would allow a contingent creditor to qualify as a complainant. Justice Pattillo concluded that it was not "plain and obvious" on the motion to strike that, at trial, the plaintiff would not be found to be a complainant. Therefore, the oppression claim was allowed to proceed to trial.[168]

In *1413910 Ontario Inc. (c.o.b. as Bulls Eye Steakhouse and Grill) v. McLennan*,[169] which was another asset-stripping case, Justice Campbell held that a tenant was a complainant. The tenant obtained partial summary judgment against its landlord and, before damages could be assessed, the landlord sold its plaza, being its only asset, and used the net proceeds to pay amounts owing to its sole shareholder. Justice Campbell awarded judgment against the shareholder in favour of the tenant. In so doing, Justice Campbell accepted the notion that a contingent creditor cannot reasonably expect that a defendant corporation will be operated simply for the contingent creditor's benefit in the

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[168] *Ibid.* at paras. 30-32.

[169] *1413910 Ontario Inc. (c.o.b. Bulls Eye Steakhouse & Grill) v. McLennan* (2008), 53 B.L.R. (4th) 115 (Ont. S.C.J.), additional reasons (2008), 53 B.L.R. (4th) 125 (Ont. S.C.J.), aff'd (2009), 309 D.L.R. (4th) 756 (Ont. C.A.) [*Bulls Eye Steakhouse*].

event that it becomes a judgment creditor. Justice Campbell concluded that there must be facts in existence that create some form of holding out by the defendant that the claim can be satisfied, so as to create a reasonable expectation. In *Bulls Eye Steakhouse*, such a reasonable expectation had been created because, previously, the contingent creditor had brought an unsuccessful motion to appoint a receiver. On that motion, responding affidavits had been filed and cross-examinations on affidavits had taken place, thereby giving rise to a reasonable expectation that, after the close of the pending sale of the plaza, sufficient funds would be held in the event of judgment being awarded.[170]

(III) Defining Oppressive Conduct

In order to avail themselves of the oppression remedy, shareholders and creditors will need to satisfy the second branch of the test upon qualifying as a complaint and the court accepting the reasonable expectation asserted by the complainant. What does it mean for directors to act in such a way as to violate the reasonable expectations of shareholders or creditors, being the second branch of the oppression remedy test that was established in *BCE*? The law arising under the oppression remedy was thoroughly analysed and summarized by the Manitoba Court of Appeal in *Danylchuk v. Wolinsky*[171] in the context of an oppression remedy claim by shareholder creditors against shareholder directors. The Manitoba Court of Appeal cited with approval the following definitions of the elements of the oppression remedy.

> "Oppressive" has been defined as "burdensome, harsh and wrongful." As to "unfairly prejudicial", "unfair" has been taken to

[170] *Ibid.* at paras. 39-45.

[171] *Danylchuk v. Wolinsky* (2007), 287 D.L.R. (4th) 646 (Man. C.A.) [*Danylchuk*].

> mean inequitable or unjust and "prejudicial" as detrimental or damaging to the applicant's right or interests. "Unfairly disregard" has been treated as meaning to unjustly or without cause pay no attention to or treat as of no importance the interests of complainants.[172]

The Manitoba Court of Appeal also adopted the statements of Hamilton J.A. in *Cohen v. Jonco Holdings Ltd.,*[173] citing with approval the analysis of John Campion, Stephanie A. Brown, and Alistair H. Crawley,[174] that "unfairly prejudicial" looks at the effect of the conduct (that is, whether the result was unfair) and "unfairly disregards" looks at whether the process was unfair.[175]

A further principle to be highlighted with respect to the oppression remedy is that "evidence of bad faith or want of probity in the action complained of is unnecessary" to qualify for judicial relief.[176] Upon finding "oppression", the court may make any order that it thinks fit to remedy the conduct about which a complaint has been made.[177] In this regard, the oppression remedy is "a remedy of maximum discretion".[178] Lastly, it is worthy to note that the statutory oppression remedy under the Ontario *Business*

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[172] *Ibid.* at para. 22 citing with approval Justice Hunt in *Novel Energy (North America) Ltd. v. Glowicki* (1994), 148 A.R. 161 (Q.B.).

[173] *Cohen v. Jonco Holdings Ltd.* (2005), 192 Man. R. (2d) 252 (C.A.).

[174] John Campion, Stephanie A. Brown, and Alistair H. Crawley, "The Oppression Remedy: Reasonable Expectations of Shareholders" [1995] Special Lectures, LSUC Law and Remedies 229.

[175] *Danylchuk, supra* note 171 at para. 22

[176] Thomson, *supra* note 153 citing *Brant Investments Ltd. v. Keep Right Inc.* (1991), 3 O.R. (3d) 289 (C.A.); *Sidaplex – Plastic Suppliers Inc. v. Elta Group Inc.* (1998), 40 O.R. (3d) 563 (C.A.) [*Sidaplex*], and *Downtown Eatery*, *supra* note 161.

[177] *Danylchuk*, *supra* note 171 at para. 45.

[178] Hon. James Farley, Q.C., Roger J. Chouinard and Nicholas Daube, "Expectations Of Fairness: The State of the Oppression Remedy in Canada Today" (2007), 33 Advocates' Quarterly 261 at 262.

Corporations Act may be more expansive than the statutory oppression remedies in other provincial corporations statutes, and in the *CBCA,* in that it provides protection against any act or omission that "*threatens* to effect a result... that is oppressive or unfairly prejudicial or that unfairly disregards the interests" of eligible complainants.[179] Therefore, the statutory oppression remedy under the Ontario *Business Corporations Act* may be used to address anticipatory oppression.

(IV) Personal Liability of Directors For Oppressing Shareholders and Creditors

Directors need only look at the abundance of jurisprudence arising from judicial decisions to appreciate that they are exposed to a real and onerous risk of personal liability under the oppression remedy. The threat of personal liability, and the assumption that directors will conduct themselves so as to avoid it, influences directors to honour reasonable expectations. Thus, the effectiveness of this intended consequence will depend on the level and nature of a director's personal liability for breaching the duty. To illustrate that the oppression remedy does give rise to a real and onerous risk of personal liability being imposed by the courts on directors for breaching reasonable expectations, the following four judicial decisions are offered as representative case studies.

In *Remo Valente Real Estate (1998) Ltd. v. Portofino Riverside Tower Inc.*,[180] a case dealing with a corporate reorganization for the purpose of defeating an exclusive listing agreement for the sale of condominiums, Justice Brockenshire held that the

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[179] *Ibid.* at 268 [emphasis added]. See also *Business Corporations Act*, R.S.O. 1990, c. B.19, s. 248.

[180] *Remo Valente Real Estate (1998) Ltd. v. Portofino Riverside Tower Inc.* (2007), 86 O.R. (3d) 667 (S.C.J.).

directors' conduct was "oppressive" and awarded $1 million in damages against the directors personally in favour of the creditor realtor. In *Prime Computer of Canada Ltd. v. Jeffrey*,[181] a case in which a director awarded himself a significant salary increase in the face of a judgment debt against the corporation and corporate cash flow problems, Justice Smith held that the director's conduct was oppressive and ordered the director to pay to the sheriff $79,700 to the credit of the plaintiff, representing the unwarranted increase in salary.

In *Danylchuk*,[182] the Manitoba Court of Appeal considered a case of directors, who were also shareholders, using companies as their personal bank accounts and making unauthorized payments of personal expenses or expenses that had no corporate purpose to the prejudice of other shareholders, who were also creditors that had advanced loans to the companies. The court upheld the application judge's finding of "oppression" and the monetary award against the director respondents personally in the amount of $875,000, being one-half of the shareholder loans owing to the applicants. Only one-half of the shareholder loans were ordered to be repaid, as the judge was of the view that the applicants may have lost their investment in any event, even without the oppressive conduct that was the subject of the complaint.

In *Sidaplex-Plastics Supplies Inc. v. Elta Group Inc.*,[183] the Ontario Court of Appeal dealt with an appeal from the decision of Justice Blair of the General Division-Commercial List, which, in part, held a director personally liable to a judgment creditor

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[181] *Prime Computer of Canada Ltd. v. Jeffrey* (1991), 6 O.R. (3d) 733 (Gen. Div.).

[182] *Danylchuk, supra* note 171.

[183] *Sidaplex, supra* note 176.

under the oppression remedy. In this case, Sidaplex-Plastics Supplies Inc. ("Sidaplex") had a consent judgment against Elta Group Inc. ("Elta") and the parties agreed that the judgment would not be enforced pending the determination of other issues that were in dispute between them. As security for the consent judgment, Elta provided Sidaplex with a letter of credit. Inadvertently, the letter of credit was made for a fixed term and was not renewed upon expiration. Elta sold off substantially all of its assets to pay other creditors, leaving Sidaplex unable to collect its judgment when the time came, as the letter of credit had expired and Elta had no assets. Sidaplex brought an application for an oppression remedy against the director of Elta, seeking judgment against him in the amount of the outstanding judgment against Elta.

Justice Blair held that the director's failure to renew the letter of credit was an omission that attracted liability under the oppression remedy in that it was unfairly prejudicial to the interests of the judgment creditor, Sidaplex, and ordered the director of Elta to pay to Sidaplex the sum of $97,076.36, being the amount of the judgment debt against Elta that should have been secured by the letter of credit.[184] In coming to his decision, Justice Blair found that the director of Elta had received a personal benefit in selling off all of the assets of Elta and paying other creditors, as this resulted in the release of his personal guarantee of certain of Elta's obligations. This personal benefit was derived by the director of Elta as a result of his omission in failing to renew the letter of credit and selling the assets of Elta to the prejudice of Sidaplex. It was, or ought to have been, immaterial, as the Ontario Court of Appeal, in upholding Justice Blair's decision to impose personal liability on the director, made a point of emphasizing that, in

[184] *Ibid.* at para. 3.

order to obtain an oppression remedy, it was not necessary to prove bad faith or want of probity.[185]

It is difficult to overturn on appeal a finding of personal liability against a director under the oppression remedy. The Ontario Court of Appeal acknowledged its limited power of review on appeals of oppression remedy cases, as, under the oppression remedy, the court at first instance may make any order that "it thinks fit", thereby giving the court "at first instance a broad discretion and the appellate court a limited power of review".[186] Thus, directors not only face a real risk of personal liability but also one that will be difficult to overturn on appeal.

In *Sidaplex*, the Ontario Court of Appeal cited with approval the following reasons for decision of Justice Blair, in which Justice Blair imposed personal liability on the directors.

> Courts have made orders against directors personally, in oppression remedy cases... These cases, in particular, have involved small, closely held corporations, where the director whose conduct was attacked has been the sole controlling owner of the corporation and its sole and directing mind; and where the conduct in question has redounded directly to the benefit of that person...
>
> Lawyers and judges tend to worry and fuss a great deal about whether or not a given set of circumstances permits the piercing of the "corporate veil"... [T]he issue, in my view, is not so much one of piercing the corporate veil as it is a question of the overall application of s. 248(2) of the *OBCA* and the interplay between its various provisions...

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[185] *Ibid.* at para. 4.

[186] *Ibid.* at para. 4.

> When the power of the director is exercised in a fashion which causes an act or omission of the corporation which effects an unfairly prejudicial result, or a result which unfairly disregards the interests of the complainant – or which causes the business or affairs of the corporation to be conducted in a manner which has the same effect – those powers themselves have been "exercised in a manner" which is caught by the section, in my opinion. Liability therefore lies directly with the director, under the section, in appropriate cases.[187]

The Court of Appeal could find no "error in principle" in these words. There is a real and effective risk of personal liability that is imposed on directors via the oppression remedy. This is made clear in the foregoing four representative case studies and by the asset-stripping cases that were reviewed earlier in this chapter.

(V) Requirement for Culpable Conduct Needed to Support Personal Liability

In the above oppression remedy cases involving director liability, there appears to have been some element of personal gain, preferential treatment, or bad faith in respect of the conduct of the director under review. Therefore, it would appear, based on these cases, that courts are somewhat reluctant to impose personal liability on directors in favour of creditors without the existence of one of these elements, notwithstanding clear judicial pronouncements that it is not necessary to prove bad faith or lack of probity as an element of an oppression remedy claim.

The fact that the directors in *USF Red Star* ordered cartage services knowing that the company could not pay for them arguably constitutes conduct that falls within the realm of bad faith or want of probity. Thus, the trend in judicial decisions of imposing liability on directors for conduct of this nature makes it arguable that personal liability

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[187] *Ibid.* at paras. 3-4.

should have been imposed on the directors for oppressive conduct in *USF Red Star*. Although Justice Hawkin interpreted the conduct of the directors differently, he did nonetheless recognize what appears to be a judicial trend requiring some element of personal gain, preferential treatment, or bad faith or want of probity on the part of directors for personal liability to attach for oppressive conduct, again notwithstanding judicial pronouncements that such elements are not required to prove oppression. In particular, Justice Hawkin cited with approval the following passage from the Ontario Court of Appeal in *Montreal Trust Co. of Canada v. ScotiaMcLeod Inc.*[188]

> The decided cases in which employees and officers of companies have been found personally liable for actions ostensibly carried out under a corporate name are fact-specific. In the absence of findings of fraud, deceit, dishonesty or want of authority on the part of employees or officers they are also rare.
>
> Considering that a corporation is an inanimate piece of legal machinery incapable of thought or action, the court can only determine its legal liability by assessing the conduct of those who caused the company to act in the way that it did. This does not mean, however, that if the actions of the directing minds are found wanting, that personal liability will flow through the corporation to those who caused it to act as it did. To hold the directors of Peoples personally liable, there must be some activity on their part that takes them out of the role of directing minds of the corporation. In this case there are no such allegations.[189]

When courts are asked to impose personal liability on directors under the oppression remedy, they are not "piercing the corporate veil". Rather, the court is being asked to use its statutory discretionary power to remedy the situation under examination by imposing personal liability on directors. Nonetheless, the effect on directors is the

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[188] *Montreal Trust Co. of Canada v. ScotiaMcLeod Inc.* (1995), 26 O.R. (3d) 481 (C.A.) at 490-491.

[189] *USF Red Star, supra* note 163 at para. 21.

same whether resulting from statutory liability or the court's exercise of its inherent jurisdiction to "pierce the corporate veil". In either case, the court is being asked, and is given the power, to look past the separate legal personality of the corporation and grant relief personally against the directors. Regardless of the legal concept that is employed to attack directors personally, it appears that the courts require some form of behaviour on the part of directors that justifies imposing personal liability on them for corporate conduct. For example, in *Alvi v. Misir,*[190] Justice Cameron had to consider the circumstances in which directors will be held to owe a fiduciary duty or duty of care to someone other than the corporation and, thus, have personal liability. Justice Cameron explained the circumstances under which directors will have personal liability as follows.

> 1. participation in tortious conduct towards persons who have not accepted the principle of limited liability or have not knowingly elected to deal with a corporation…and
>
> 2. fraud, dishonesty, want of authority or other conduct specifically pleaded which justifies piercing the corporate veil, the corporate veil is a sham or where the conduct exhibits a separate identity of interest from the *bona fide* interests of the corporation...[191]

The law, therefore, is unclear whether claims by shareholders and creditors against directors for personal liability due to oppressive conduct require proof of personal gain, preferential treatment, or bad faith or want of probity. On the one hand, judicial pronouncements defining the elements of oppression say that such conduct is not an element of oppression. On the other hand, when examining the cases in which personal liability for oppressive conduct has attached to directors, and in particular the facts of

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[190] *Alvi v. Misir* (2004), 73 O.R. (3d) 566 (S.C.J.) [*Alvi*].

[191] *Ibid.* at para. 52.

these cases, there seems to be a judicial trend of requiring some form of conduct that the court considers to be culpable and worthy of attracting personal liability for oppressive conduct. As Justice Farley cautioned, in applying the oppression remedy, "the surgery should be done with a scalpel and not a battle axe ... even if the past conduct of the oppressor were found to be scandalous".[192]

In cases where directors are protected by liability insurance, it can be assumed that directors will nonetheless still attempt to conduct themselves within the parameters of the law and, in particular, the law of oppression for the following five reasons. First, acting within the law is the commercially moral way to act. Second, directors will want to avoid the increased premiums and deductibles that will have to be paid by the corporation and that go along with claims that are made against directors. Third, insurance coverage is not necessarily an absolute shield protecting against wrongful conduct.[193] Fourth, directors will not want to risk failing to qualify for liability insurance coverage upon renewal of the policy as a result of too many claims having been made. Lastly, claims against directors may give rise to criticism with respect to the performance of their duties and responsibilities, which ultimately may lead to their replacement as directors.

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[192] Farley, Chouinard, and Daube, *supra* note 178 at 272.

[193] For general discussion of the nature and scope of directors' and officers' liability insurance in Canada, see Donley and Kent, *supra* note 99.

(C) Influence of the Oppression Remedy on Pluralistic Concept for Acting in Best Interests of Corporation

Given the nature and scope of the statutory oppression remedy, it is arguable that it was not necessary to replace the traditional shareholder primacy model with a pluralistic one in order to require directors to consider and fairly balance the interests of shareholders and creditors in defining what it means to act in the best interests of the corporation. Even so, that is exactly what the Supreme Court of Canada did in *People's* and, thereafter, in *BCE*. Furthermore, in *BCE*, the Supreme Court of Canada elaborated on the pluralistic concept of best interests of the corporation by incorporating therein oppression remedy principles.

The Supreme Court of Canada in *BCE* reiterated its remarks in *People's* by saying that, "although directors must consider the best interests of the corporation, it also may be appropriate, although not mandatory, to consider the impact of the corporation's decisions on shareholders or particular groups of stakeholders".[194] Thus, the Supreme Court of Canada repeated that the pluralistic decision-making model was permissive, in that directors "may" consider the interests of stakeholders. However, using oppression law principles, the court seems to have gone on to create a mandatory form of the pluralistic decision-making model.

In particular, the Supreme Court of Canada, in *BCE*, added an element to the pluralistic definition of what it means to act in the best interests of the corporation: a positive requirement to treat equitably and fairly all stakeholders who are affected by the

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[194] *BCE, supra* note 14 at para. 39.

decision because, according to the court, that is what they are entitled to reasonably expect. The court wrote that,

> …the corporation and shareholders are entitled to maximize profit and share value, to be sure, but not by treating individual stakeholders unfairly. That treatment – the central theme running through the oppression jurisprudence – is most fundamentally what stakeholders are entitled to 'reasonably expect'.[195]

Thus, directors have been directed by the court to treat all stakeholders equitably and fairly in the corporate decision-making process so as to honour their reasonable expectation to be treated as such. From a practical perspective, this can only be accomplished by directors seeking out and determining which stakeholders may be affected by the contemplated corporate transaction and then ensuring that the various interests in this constituency are treated fairly and equitably.

Shareholders and creditors are the two main corporate stakeholders. The oppression remedy gives rise to a powerful influence on directors to honour the reasonable expectations of these two corporate stakeholders by threat of personal liability. A subsequent pluralistic decision-making model for what it means to act in the best interests of the corporation does not give rise to any additional reason for directors to consider the reasonable interests of shareholders and creditors in the corporate decision making process. The pluralistic decision-making model is redundant as far as shareholders and creditors are concerned. Moreover, it displaced the traditional shareholder primacy model without any examination as to the rationale behind it and whether and to what extent this rationale should be disturbed to provide further

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[195] *Ibid.* at para. 64.

protection, over and above existing laws arising by statute, common law, and in equity, for protection of stakeholder interests.

CHAPTER 6

A STATEMENT OF THE LAW ARISING FROM *PEOPLE'S*

(A) Introduction

The starting point in the in Canada for examining the statutory duties of directors in an insolvency or situation of financial distress is the decision of the Supreme Court of Canada in *People's*. The issue in *People's* was the decision of the corporation's directors to implement a joint inventory procurement policy between People's and its parent company Wise. This policy saw People's making all inventory purchases from North American suppliers for both People's and Wise, and Wise, in turn, making all purchases from overseas suppliers for the two companies. People's would then sell to Wise and charge Wise accordingly and vice versa. This arrangement was more favourable to Wise than to People's in that eighty-two per cent of total inventory that was purchased came from North American suppliers, resulting in a significant trade receivable owing from Wise to People's. The policy was implemented on February 1, 1994 and, by April 30, 1994, Wise owed People's fourteen million dollars under the policy. Marks & Spencer had sold People's to Wise and had financed the purchase price with security over People's assets. The purchase price financing terms contained certain financial covenants, including a prohibition against People's providing financial assistance to Wise. Marks & Spencer took the position that People's financing of inventory for Wise under the policy breached the purchase price financing terms and, thus, it demanded that the policy be rescinded.

By December 1994, Marks & Spencer initiated bankruptcy proceedings against both People's and Wise and both became bankrupt. The sale of the assets of People's and Wise raised sufficient money to pay the secured creditors and the landlords' claims. The balance of creditors with unsatisfied claims were unsecured creditors. They consisted substantially of trade creditors. The receivable that was owing from Wise to People's was not collectible, to the prejudice of People's unsecured creditors. The trustee in bankruptcy for the unsecured creditors of People's took issue with the actions of its directors in deciding upon and implementing a policy that provided financial assistance to a related company to the detriment of People's and its creditors.

It was in the context of the foregoing facts that the Supreme Court of Canada examined the statutory fiduciary duty and duty of care imposed on directors, and the effect of the oppression remedy on the conduct of directors, arising under the *CBCA*.[196] The statutory fiduciary duty requires directors to act in the best interests of the corporation. The statutory duty of care requires directors to exercise the care, diligence, and skill of a reasonably prudent director in comparable circumstances. The oppression remedy imposes personal liability on directors for conduct that is oppressive of, among others, shareholders and creditors or that is unfairly prejudicial to or that unfairly disregards their interests.

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[196] These are known as the fiduciary duty, the duty of care, and the oppression remedy. The first two of these duties are found in s. 122(1)(a) and (b) of the *CBCA*, *supra* note 1. This section imposes on "[e]very director and officer of a corporation in exercising their powers and discharging their duties [to] (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". The oppression remedy was discussed in Chapter 5 above. The oppression remedy arises under s. 241(1),(2), and (3) of the *CBCA*, *supra* note 1. In short, it requires directors and officers not to exercise their powers "in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any" shareholder or creditor. The provincial corporations statutes contain similar statutory duties and an oppression remedy.

The trustee in bankruptcy commenced the action for the unsecured creditors of People's as a result of alleged breaches of the statutory fiduciary duty and duty of care under the *CBCA*. The trustee in bankruptcy's position was that these duties were owed by the directors to the unsecured creditors and had been breached.[197] The Supreme Court of Canada held that the fiduciary duty was owed only to the corporation, not to the creditors, and that, while the duty of care might be owed to the creditors, it had not been breached. Although the trustee did not include an oppression remedy claim on behalf of the unsecured creditors against the directors, the Supreme Court nonetheless felt it necessary to point out that it was open to creditors to pursue directors under the oppression remedy and, thus, they were not left without a remedy by restricting the fiduciary duty to the corporation.[198] Based on the Supreme Court of Canada's decision in *People's*, directors owe a statutory fiduciary duty to the corporation, a statutory duty of care to the corporation and potentially its stakeholders,[199] both giving rise to personal liability if breached, and directors will be held personally liable if their conduct oppresses the corporation's shareholders and creditors by disregarding their reasonable

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[197] *SCC People's*, *supra* note 16 at para. 30.

[198] *Ibid.* at paras. 51-57. Even though the fiduciary duty is owed to the corporation, it may nonetheless be enforced by creditors by way of derivative claim on behalf of the corporation, thereby recovering for the corporation any loss or damages suffered by it in which the creditors would be entitled to share.

[199] While this paper does not concern itself with the statutory duty of care, it is important to note that the statutory duty of care does not give rise to a cause of action by stakeholders against directors. The cause of action arises under the common law tort of negligence. The existence of the statutory duty of care may be taken into account by the court in determining the standard of behaviour that should be reasonably expected. Furthermore, the law as to whether directors owe a common law duty of care to creditors remains to be determined. That will depend on the application of the two-part test for determining whether a duty of care arises. This two-part test is firstly based on foreseeability and sufficient proximity, which will give rise to a duty of care. However, the second part of the test requires an examination of whether there may be public policy reasons for not allowing the duty of care to stand. In the case of a potential duty of care to creditors, relevant policy reasons negating the existence of any duty may be the potential for indeterminate personal liability of directors and conflicting duties to the corporation and creditors for a director to discharge. See: *Festival Hall Developments Ltd. v. Michael Wilkngs* (2009), 57 B.L.R. 210 (Ont. S.C.J.).

expectations. Given the Supreme Court of Canada's pluralistic interpretation of the statutory fiduciary duty to act in the best interests of the corporation, all three of foregoing concepts under Canadian law are pluralistic in nature. This has resulted in the marginalization of the maximization of corporate value principle, being the rationale behind the shareholder primacy interpretation of acting in the best interests of the corporation. This increase in the level of pluralism in corporate decision-making was done at the expense of the maximization of corporate value principle without any cost-benefit analysis.

(B) The Potential Conflict of Interest Raised by *People's*

The Supreme Court's decision in *People's* exposed a potential conflict of interest for directors between the interests of the corporation and stakeholders. Under the statutory fiduciary duty and duty of care, directors owe simultaneous duties to the corporation and potentially to its stakeholders, such as its shareholders and creditors. This would put directors in a conflict of interest situation if they had to choose between the competing interests of the corporation and stakeholders. Under the oppression remedy, an onus is placed on directors to honour the reasonable expectations of shareholders and creditors. At the same time, directors have a duty to act in the best interests of the corporation. Again, directors would be put in a conflict of interest situation if the reasonable expectations of shareholders and creditors were not consistent with the best interests of the corporation. An insolvency or deteriorating financial situation would be an obvious scenario giving rise to a potential conflict of interest for directors. The dilemma raised for directors is whose interests should they be looking to

favour as between the corporation, shareholders, and creditors when not all economic interests can be fully satisfied?

Justice Cameron noted this conflict in *Alvi v. Misir*,[200] a case in which the shareholders commenced proceedings against the directors for, among other things, negligence and breach of fiduciary duty. *Alvi* was decided after the Supreme Court of Canada's decision in *People's*. In dismissing the claim of the shareholders against the directors, the court held the following.

> [i]n view of the fact that the statutory duties of good faith, loyalty and care are owed to the corporation, the directors cannot have separate duties of the same nature owing to the shareholders. Such parallel duties would create untenable and unrealistic conflicts. They would render impossible the position of a director or officer of a corporation, particularly where the corporation is faced with adverse economic circumstances...
>
> The same reasoning must apply to any claim based on fiduciary duty in equity. Such a duty overlaps substantially the statutory duty to the corporation to act honestly and in good faith and in the best interests of the corporation.[201]

In *Alvi,* the court concluded that a director's duty to the corporation is paramount in the event of conflict with a director's duty to shareholders. Subsequently, in *BCE*, the Supreme Court of Canada extended the paramountcy of a director's duty to the corporation over any duty owed to stakeholders.

The Supreme Court of Canada took the opportunity in *BCE* to make it clear that any conflict between a director's duty to act in the best interests of the corporation and a

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[200] *Alvi, supra* note 190.

[201] *Ibid.* at paras. 57-58.

director's intention to honour reasonable expectations of shareholders and creditors under the oppression remedy, was to be settled in favour of the corporation. The court wrote the following.

> The fact that the conduct of the directors is often at the centre of oppression actions might seem to suggest that directors are under a direct duty to individual stakeholders who may be effected by a corporate decision … People sometimes speak in terms of directors owing a duty to both the corporation and to stakeholders. Usually this is harmless, since the reasonable expectations of the stakeholders in a particular outcome often coincide with what is in the best interests of the corporation. However, cases (such as these appeals) may arise where these interests do not coincide. In such cases it is important to be clear that the directors owe their duty to the corporation, not to stakeholders, and that the reasonable expectation of stakeholders is simply that the directors act in the best interests of the corporation…viewed as a good corporate citizen.[202]

Given this pronouncement, directors will be excused from acting oppressively against shareholders and creditors, under the oppression remedy, if their actions are in the best interests of the corporation. While the Supreme Court of Canada's foregoing remarks were made in the context of an analysis of a potential conflict between a director's duty to act in the best interests of the corporation and a director's desire not to oppress, unfairly prejudice, or unfairly disregard the interests of creditors under the oppression remedy, the remarks would apply to any conflict between a director's duty to the corporation and a director's duty or inclination to protect the interests of third parties as, after all, the Supreme Court of Canada leaves no question but that the duty to the corporation to act in its best interests is to be paramount.

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[202] *BCE, supra* note 14 at paras. 66 and 81.

(C) What Does it Mean for Directors to Act in the Best Interests of the Corporation? A Pluralistic Corporate Decision-Making Model

The Supreme Court of Canada in *People's* used these words to describe the nature and scope of a director's paramount duty to act in the best interests of the corporation.

> We accept as an accurate statement of law that in determining whether (directors) are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of the case, for the board of directors to consider, inter alia, the interests of the shareholders, employees, suppliers, creditors, consumers, governments and the environment.
>
> The various shifts in interests that naturally occur as a corporation's fortunes rise and fall do not, however, affect the content of the fiduciary duty under Section 122 (1)(a) of the CBCA. At all time, directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders …
>
> …In resolving these competing interests, it is incumbent on the directors to act honestly and in good faith with a view to the best interests of the corporation. In using their skills for the benefit of the corporation when it is in troubled waters financially, the directors must be careful to attempt to act in its best interests by creating "better" corporation, and not favour the interests of any one group of stakeholders.[203]

Lee succinctly and simply summarizes the state of the law arising from the Supreme Court of Canada's decision in *People's* as follows.

> The Supreme Court does not flesh out the concept of the "best interest of the corporation", except to tell us that it is not synonymous with the best interests of the shareholders; that the interests of shareholders and non-shareholders alike may be taken into account, although none is paramount; and that the board should strive to "creat[e] a 'better' corporation". In other words, other than ruling out monism [i.e., the shareholder primacy

[203] *SCC Peoples, supra* note 16 at paras. 42, 43, 46, and 47.

> decision-making model], the court essentially leaves the definition of "best interests of the corporation" to the board of directors.[204]

As can be seen, the Supreme Court of Canada in *People's* adopted a permissive pluralistic decision-making model for directors. In other words, it was permissible for directors to consider the interests of any affected stakeholder in striving to create a "better" corporation, but such consideration was not mandatory. As a result, directors could not be criticized for departing from the traditional decision-making model, where acting in the best interests of the corporation was defined as maximizing profit for corporation's shareholders, if to do so was what reasonably needed to be done in the circumstances to create a "better" corporation.

The Supreme Court of Canada in *BCE* converted the pluralistic decision-making model into a mandatory one by mandating directors to treat all affected stakeholders equitably and fairly in the decision-making process. It said that that "is most fundamentally what stakeholders are entitled to reasonably expect."[205]

(D) What "Long Recognized" Legal Principle?

In choosing a pluralistic decision-making model over a shareholder primacy model, shifting to a creditor primacy model upon financial distress or insolvency, the Supreme Court of Canada in *People's* chose to rely on and follow a "long recognized" Canadian legal principle. In this regard, the Supreme Court of Canada wrote the following.

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[204] Lee, "Corporate Law", *supra* note 34 at 26. Monism is better known as the shareholder primacy model.

[205] *BCE, supra* note 14 at para. 64.

> …it is clear that the phrase the "best interests of the corporation" should be read not simply as the "best interests of the shareholders". From an economic perspective, the "best interests of the corporation" means the maximization of the value of the corporation... However, the courts have ***long recognized*** that various other factors may be relevant in determining what directors should consider in soundly managing with a view to the best interests of the corporation. For example, in *Teck Corp. v. Millar* (1972), 33 D.L.R. (3d) 288 (B.C.S.C.), Berger J. stated, at p. 314:
>
>> A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting *bona fide* in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered *bona fide* the interests of the shareholders.
>>
>> I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees: *Parke v. Daily News Ltd.*, [1962] Ch. 927. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.
>
> The case of *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254 (Div. Ct.), approved, at p. 271, the decision in *Teck*, *supra*. We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.[206]

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[206] *SCC Peoples, supra* note 16 at para. 42 [emphasis added].

Lee demonstrates that the pluralistic corporate decision-making model that was endorsed by the Supreme Court of Canada was not, as stated by the court, a "long recognized" principle of Canadian law.[207] After reviewing Justice Berger's reasons for decision in *Teck Corp. v. Millar*,[208] including the reasons for decision in the English decision of *Parke v. Daily News Ltd.*[209] to which Berger J. referred, and after reviewing the judicial treatment of *Teck* and *Parke* in Canada prior to the Supreme Court of Canada's decision in *People's*, Lee concludes the following.

> *Teck* is not, contrary to the court's suggestion, exemplary of a position "long recognized" by the courts. It is a solitary judicial endorsement, likely *obiter*, of a controversial legal proposition.[210]

With respect to the Supreme Court of Canada's reliance on *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.*[211] as being a case following and applying Justice Berger's pluralistic corporate decision-making model, Lee concludes that such reliance by the court to support what it says is a "long recognized" Canadian legal principle is "[e]qually questionable".[212] Lee points out that *Re: Olympia & York* contains no reference to Justice Berger's pluralistic definition of corporate decision-

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[207] Ian B. Lee, "People's Department Stores v. Wise and the 'Best Interests of the Corporation'" (2004), 41 Can. Bus. L. J. 212 at 213-217 [Lee, "People's"].

[208] *Teck Corp. v. Millar* (1972), 33 D.L.R. (3d) 288 (B.C.S.C.) [*Teck*] as cited in *SCC Peoples, supra* note 16 at para. 42.

[209] *Parke v. Daily News Ltd.*, [1962] Ch. 927 [*Parke*] as cited in *SCC Peoples, supra* note 16 at para. 42.

[210] Lee, "People's", *supra* note 207 at 217.

[211] *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254 (Div. Ct.) [*Re Olympia & York*] as cited in *SCC Peoples, supra* note 16 at para. 42.

[212] Lee, "People's", *supra* note 207 at 217.

making and that, while the Ontario Divisional Court did cite *Teck*, it quoted from a different part of Justice Berger's opinion. He notes that the court relied on *Teck* for its finding that the directors had not violated their duties in resisting a hostile takeover that they believed was contrary to the interests of the shareholders, as they had taken "all reasonable steps to maximize value for all shareholders".[213]

As the Supreme Court of Canada failed to deal with the underlying debate and instead chose to rely on a questionable "long recognized" Canadian legal principle, the debate as to which model of corporate decision-making we should impose on directors has not been settled on a principled basis by the court.

(E) Statement of Law as to Nature of Corporate Decision-Making Model in Canada for Acting in the Best Interests of the Corporation

In general terms, a director's duty to act in the best interests of the corporation means that directors are required to exercise their powers of office to strive to create a "better corporation", as directed by the Supreme Court of Canada's in *People's*, and to have the corporation act as a "good corporate citizen", as directed by the Supreme Court of Canada's in *BCE*. This mandate is to be carried out with regard to the interests of affected stakeholders.

More specifically, how Canadian law interprets what it means for directors to act in the best interests of the corporation may be broken down into the following elements.

(a) Directors have a primary duty to act in the best interests of the corporation.

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[213] *Ibid.* at fn. 25.

(b) From an economic perspective, this means maximizing corporate value. However, this objective is qualified in that directors must ascertain the reasonable interests of affected stakeholders and treat those reasonable interests fairly and equitably in the corporate decision-making process, failing which they will not have acted in the best interests of the corporation. Shareholders and creditors, in particular, are afforded specific protection against directors exercising their powers in such a way as to oppress them by disregarding their reasonable expectations.

(c) The existence and scope of the reasonable interests of affected stakeholders that must be treated fairly and equitable, and the reasonable expectations of shareholders and creditors that are to be honoured, are to be informed by an examination of the following facts: general commercial practice; the nature of the corporation; the relationships among the parties; past practices of the parties; measures that the affected stakeholder could have taken to protect itself from experiencing or suffering the harm complained about; representations and agreements; and, the fair resolution of conflicting interests among corporate stakeholders.

(d) As demonstrated in Chapter 2, when a corporation is profitable, is well-capitalized, and has good prospects, the objective of maximizing corporate value generally benefits all stakeholders, but when a corporation begins to experience financial distress or becomes insolvent, the reasonable interests of the stakeholders may begin to compete and conflict with the

> corporation and one another. In the event of such conflict, as demonstrated in this chapter, it must be resolved in accordance with what is in the best interests of the corporation. Any conflict between the interests of the corporation and the interests of the stakeholders is to be resolved in favour of the corporation.

As is evident from the above, a complicated pluralistic decision-making model is the governing doctrine in Canada for what it means for directors to act in the best interests of the corporation. One would think that the Supreme Court of Canada in *People's* and *BCE* would have arrived at such an intricate pluralistic decision-making model after careful consideration of the underlying debate among competing corporate decision-making models for what it means for directors to discharge their paramount duty to act in the best interests of the corporation. One also would expect a more careful analysis of whether the introduction of a pluralistic decision-making model was necessary given the nature and scope of the available statutory oppression remedy. A more focused and goal oriented model would have resulted from not disturbing the traditional shareholder primacy model, with a shift to a creditor primacy model upon financial distress or insolvency. This would have resulted in a mandate to directors, under all circumstances, to maximize corporate value for the general benefit of society, within the parameters and constraints of the laws arising from corporate statutory law, statutory laws of a regulatory nature, common law, and in equity.

Despite the Supreme Court of Canada's endorsement of pluralism as being the law in Canada for what it means to act in the best interests of the corporation, and the resulting dilution of the traditional economic rational for this meaning, it seems that

judges continue to view corporations from the traditional perspective of existing fundamentally for an economic purpose and the actions of directors being judged from that perspective. For example, Justice Wilton-Siegel recently undertook an objective economic approach in determining whether a director breached his statutory fiduciary duty to the corporation by directing the corporation to make a number of recorded unsecured loans to other corporations for real estate investments.[214] The director had a controlling interest in the other corporations. Justice Wilton-Siegel held that an "objective test" was to be applied in determining whether the director acted in good faith and in the best interests of the corporation.[215] The judge determined that the loans were "highly risky", being in the nature of "equity investments", and that the "economic reality of the loans is that [the lending corporation] bore all the downside risk and [the borrowing corporations] realized all of the up-side benefit".[216] Justice Wilton-Siegel concluded,

> No reasonably prudent director would have made the loans [to the borrowing corporations related to the director] of the nature described above and on an unsecured and unguaranteed basis. The only reasonable explanation is [the director's] preferment of his own interests over those of [the corporation].[217]

For these reasons, Justice Wilton-Siegel decided that the director had not acted in good faith with a view to the best interests of the corporation. As the related borrowing

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[214] *Paragon Development Corp. v. Sonka Properties Inc.* (2009), 96 O.R. (3d) 574 (S.C.J.).

[215] *Ibid.* at para. 137.

[216] *Ibid.* at para. 138.

[217] *Ibid.* at para. 140.

corporations could not repay the loans, judgment was ordered against the director for the balances of the loans under the oppression remedy.[218]

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[218] *Ibid.* at para. 159.

CHAPTER 7

THE BUSINESS JUDGMENT RULE

I argue in this chapter that what is known as the business judgment rule supports neither pluralism, nor the shareholder primacy. It is neutral. The business judgment rule, however, creates a certain standard of care that directors must discharge in applying either model.

A review of what it means for directors, in the corporate decision-making process, to treat equitably and fairly all stakeholder interests and to pay particular attention to the reasonable expectations of shareholders and creditors would not be complete without an examination of the business judgment rule. The business judgment rule is the final judicial lens through which the courts examine and define the conduct of directors. It is the last defence that is available to directors whose conduct is impugned.

In *BCE,* the Supreme Court of Canada commented on the role of the business judgment rule in assessing the conduct of directors as follows.

> Courts should give appropriate deference to the business judgement of directors who take into account these ancillary interests [i.e. the stakeholders], as reflected in the business judgment rule. 'The business judgment rule' accords deference to a business decision so long as it lies within a range of reasonable alternatives... it reflects the reality that directors, who are mandated Section 102 (1) of the CBCA to manage the corporation's business and affairs, are often better suited to determine what is in the best interests of the corporation. This

> applies to decisions on stakeholders' interests, as much as other directorial decisions.[219]

The business judgment rule applies to and plays a prominent role in all directorial decisions that are subject to court review. Justice Farley et. al. have described the business judgment rule as "[t]he most important" limiting factor in the court's use of the oppression remedy.[220] The Supreme Court of Canada invoked the business judgment rule in order to save the directors of People's from an alleged breach of their duty of care to the unsecured creditors of People's. The Supreme Court of Canada, in *People's*, described the business judgment rule and its purpose as follows.

> … 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 someone 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…
>
> As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision…
>
> Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on reasonable informed basis… Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable on the acts of any case of determining whether any appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.[221]

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[219] *BCE, supra* note 14 at para. 40.

[220] Farley, Chouinard, and Daube, *supra* note 178 at 282.

[221] *SCC Peoples, supra* note 16 at paras. 64-68 [emphasis in original].

Clearly, the business judgment rule calls for judicial deference to be granted to directors. This call for judicial deference might cause one to question the relevancy of any corporate decision-making model for governing the behaviour of directors as, under the business judgment rule, they are given wide latitude to act within the concept of reasonableness. However, a closer look at the business judgment rule suggests that, to the contrary, it is a concept that better defines the role, or accountability, of directors, within the applicable decision making model. .

The conditions of applicability of the business judgment rule are that:

(a) directors must have acted prudently by informing themselves of the relevant facts before making their decision;

(b) directors must have acted honestly and in good faith; and,

(c) the decision made must be a reasonable option in the circumstances. .[222]

Directors will be judged therefore on the basis of whether they were diligent in informing themselves of and considered all relevant information and, then, whether the decision was within a range of reasonable options. Viewed from this perspective, the business judgment rule is more a development of the concept of objective reasonableness, whereby directors are to be judged based on what a reasonably prudent director would have done when confronted with having to reconcile the competing interests of the corporation and its stakeholders in a deteriorating financial situation or insolvency.

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[222] Rousseau, *supra* note 74 at 376. See also Farley, Chouinard, and Daube, *supra* note 178 at 283-284.

In any event, the business judgment rule works to further define the pluralistic corporate decision-making model that is applicable in Canada in that, in working within the model, directors need to diligently inform themselves of all relevant facts and act honestly and in good faith and their decision must be within a range of reasonable alternatives to be chosen.. Although the Supreme Court of Canada applied the business judgment rule to exonerate the directors in *People's*, a review of the facts of that case and the application of the business judgment rule from a different perspective provides a good illustration of the way in which the business judgment rule works to define the decision-making role of directors.

The directors of People's allowed it to finance the purchase of stock for its parent company, Wise, on unsecured credit terms. The financing of stock for Wise by People's under the joint inventory procurement policy was accomplished on terms that gave rise to People's carrying a significant unsecured receivable from Wise. This contributed to People's already-existing financial troubles because Wise could not pay the significant sum of money that it owed People's. Rousseau argues that the Quebec Court of Appeal in applying the business judgment rule, to support overturning the trial judge's finding of liability on the directors, paid insufficient attention to the relevance of process in the corporate decision-making that led to the joint inventory procurement policy.[223] He adds that a more "robust application" and a "more refined" analysis of the business judgment rule by the Quebec Court of Appeal would not have saved the directors of People's. He argues that, on the facts, it is doubtful that the directors followed a diligent decision-making process in relying on the recommendation of an experienced officer of People's

[223] Rousseau, *ibid.*

to implement the joint inventory procurement policy, as they never directed their minds to the credit-worthiness of Wise or the financial consequences for People's in carrying such a large inter-company receivable. In other words, directors cannot blindly follow professional advice as the directors of People's arguably did.[224]

Rousseau's criticism was that the Quebec Court of Appeal failed to consider that the directors of People's may have engaged in a deficient corporate decision-making process by not taking into consideration and assessing (or ignoring) the impact of the joint inventory procurement policy on People's in circumstances of existing financial stressors. This criticism would seem to apply equally to the Supreme Court of Canada's reasons for upholding the Quebec Court of Appeal's decision in *People's* on the application of the business judgment rule. The Supreme Court of Canada acknowledged the existence of "troublesome circumstances"[225] at the time at which the domestic inventory procurement plan was implemented, but it excused the directors from liability notwithstanding that it does not appear that they factored these "troublesome circumstances" into their decision-making as directors of People's. The Supreme Court of Canada did not explain why it chose the conclusions of the Quebec Court of Appeal over the trial judge in respect of the applicability of the business judgment rule to protect the directors, other than to say that,

> …[a]fter considering all the evidence, we agree with the Court of Appeal that the implementation of the new policy was a reasonable business decision that was made with a view to rectifying a serious and urgent business problem in circumstances in which no solution

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[224] *Ibid.* at 369, 377, and 379.

[225] *SCC Peoples, supra* note 16 at para. 71.

> may have been possible. The trial judge's conclusion that the policy led inexorably to People's failure and bankruptcy was factually incorrect and constituted a palpable and overriding error.[226]

There were, in essence, two factual considerations that the Supreme Court of Canada emphasized as having been overlooked by the trial judge, thus resulting in an erroneous conclusion of liability.[227] First, the court was of the view that the trial judge failed to properly appreciate that there existed other negative financial conditions that contributed to bankruptcy of People's and, thus, the joint inventory procurement policy was not the sole cause. Second, the court concluded that the trial judge overlooked the fact that there existed no "economic incentive" for the directors of People's "to jeopardize the interests of People's in favour of the interests Wise". In support of this proposition, the court pointed out that People's had tax losses to carry forward and, thus, there would have been an incentive for the directors to keep People's profitable in order to be able to take advantage of these tax losses.

These two factual considerations, concerning themselves with causation and motive, do not address the decision-making process that led to the directors of People's agreeing to put in place a questionable joint inventory procurement policy favouring a related company. Neither the Quebec Court of Appeal nor the Supreme Court of Canada took a hard look at the decision-making process that was undertaken by the directors of People's to examine if it was deficient, and thus unreasonable, due to their failure to inform themselves and consider whether the implementation of a policy favouring a

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[226] *Ibid.* at para. 68.

[227] *Ibid.* at paras. 69-71.

related company would exacerbate existing financial problems for People's. Thus, it may be argued that these courts did not properly invoke what has become known as the business judgment rule in refusing to hold the directors accountable for their actions that prejudiced both People's and its unsecured creditors.

It can be seen how the business judgment rule places a positive onus on directors to diligently inform themselves of all relevant factors and, thereafter, to base their decision on reasonable grounds in fulfilling their mandate, whether under the Canadian form of the pluralistic decision-making model or the traditional shareholder primacy model. The business judgment rule would also apply in determining when the creditor primacy model should displace the shareholder primacy model. Whatever the applicable decision making model, in applying it directors are to diligently inform themselves, act honestly and in good faith, and make a decision that falls within a range of reasonable options. In this fashion, the business judgment rule holds directors accountable.

CHAPTER 8

THE SHIFT – IS "VICINITY OF INSOLVENCY" CAPABLE OF BEING DEFINED?

If one accepts, as this paper argues, that acting in the best interests of the corporation should be equated with acting to maximize corporate value for shareholders with a shift to maximizing (which may mean preserving) corporate value for creditors when it appears that the shareholders have lost their investment, then one needs to determine when that shift should take place. Some context may help us better understand this question. From a practical perspective, as a corporation begins to experience financial distress and as its financial situation either does not get better or worsens, directors are faced with the following three basic options:

1. continue to take self-imposed restructuring measures with a view to turning around the corporation's failing financial fortunes as a going concern enterprise;

2. file for "bankruptcy protection"[228] to attempt to restructure the company under and in accordance with a regulated bankruptcy and insolvency regime that is designed to stay claims and rank stakeholder interests; or,

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[228] To "file for bankruptcy protection" is a colloquial term that is used to refer to the act of a debtor obtaining a stay of proceedings against the claims of creditors to allow the debtor an opportunity to formulate a proposal or plan for compromising its debts. Under ss. 50, 50.4, 69, and 69.1 of the *Bankruptcy and Insolvency Act,* R.S.C. 1985, c. B-3, as amended [*BIA*], this is accomplished by the debtor filing either a notice of intention to file a proposal or a proposal, following which an automatic stay of proceedings arises. Under ss. 9 to 11 of the *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, as amended [*CCAA*], this is accomplished by the debtor applying to the court for an initial stay of proceedings to allow it to formulate a restructuring plan for presentation to its creditors.

3. voluntarily cease operations and liquidate the company or assign the company into bankruptcy,[229] if necessary, to provide for an orderly liquidation process and ordering of priorities among stakeholders within a bankruptcy and insolvency regime.

This chapter concerns itself with the conduct of directors under the first option – a voluntary restructuring of the company with a view to turning it around and maintaining it as a going concern. In that context, when does the shift take place such that acting in the best interests of the corporation is to be equated with acting in the best interests of the creditors? The most common answer that is presented in judicial decisions and academic literature is that the shift should take place when the corporation is in the vicinity of insolvency, as that is when the creditors become the residual risk-bearers. The standard criticism of this argument is that "vicinity of insolvency" is too nebulous or ambiguous as a concept and, thus, it is not capable of legal definition. This chapter examines whether the vicinity of insolvency concept is capable of definition, hence supporting the proposition that the shift should occur at that point in time.

As noted in previous chapters, the Delaware Supreme Court in *North American Catholic*[230] and the Supreme Court of Canada in *People's*[231] put an end to the notion that directors owed a fiduciary duty directly to creditors to operate the corporation in their best interests when a corporation entered the vicinity of insolvency or became insolvent.

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[229] *BIA*, *ibid.* at ss. 49 and 69.3. Upon the corporation being assigned into bankruptcy by its directors, an automatic stay of proceedings against unsecured creditors arises.

[230] *North American Catholic, supra* note 29.

[231] *SCC Peoples, supra* note 16.

Both courts held that, under all circumstances, the duty of directors was owed to the corporation and if directors caused actionable injury to the company that also resulted in loss or damage to the creditors, then the creditors could pursue recovery from the directors for their breach of fiduciary duty to the corporation by way of derivative claim.

Having made the determination that a fiduciary duty to creditors does not arise when the corporation enters the vicinity of insolvency or becomes insolvent, neither the Delaware Supreme Court nor the Supreme Court of Canada was required to address the meaning of "vicinity of insolvency". This fact did not deter the Supreme Court of Canada, which held that the phrase "vicinity of insolvency" "is incapable of definition and has no legal meaning". Nevertheless, the court did concede that "[w]hat it is intended to convey is a deterioration in the corporation's financial stability".[232]

The Supreme Court of Canada's view that the concept is not capable of being defined with sufficient legal precision is supported by a number of articles. They point out that trying to define zone or vicinity of insolvency is a "guessing game".[233] It is a concept that cannot be defined because it is too "obscure",[234] "like trying to hit a fast-moving target".[235] It is a concept that is "plagued by ambiguity".[236] It is a "shapeless

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[232] *Ibid.* at paras. 45-46.

[233] Edwards, *supra* note 22 at 1.

[234] Ramesh K.S. Rao, David Simon Sokolow & Derek White, "Fiduciary Duty a la *Lyonnais*: An Economic Perspective on Corporate Governance in a Financially Distressed Firm" (1996-1997), 22 J. Corp. L. 53 at 64.

[235] *Ibid.* at 69.

[236] Kandestin, *supra* note 22 at 1240.

concept".[237] Nicholls argues that it gives rise to a variation of "Zeno's paradox", thereby minimizing the significance of the shift to maximizing corporate value for creditors. Nicholls points out that before becoming insolvent the company was "almost insolvent" and, before that, "almost almost insolvent ... [a]nd so on ... to the moment of original incorporation".[238] Consequently, the concept is not capable of legal definition. Furthermore, it has been noted that companies often slip through and into insolvency and back out again, making it difficult and perhaps unfair to shareholders to delineate an exact point in time at which directors should start focusing on protecting the investment of the creditors over that of the shareholders.[239]

It has been argued that relying on an ambiguous concept for determining when directors should switch from maximizing corporate value for shareholders to doing so for creditors results in a "notice problem" for directors, in that they do not know when to switch their focus. The argument continues that this may lead to decision-making paralysis, whereby innovative insolvency countermeasures and value-maximizing decisions are missed.[240] Nonetheless, the vicinity of insolvency distinction is an important one because, based on a value-maximizing model of corporate decision-making, it is the benchmark for the point at which the creditors become the residual risk-bearers and maximizing corporate value is to be seen through their eyes.

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[237] *Ibid.* at 1265.

[238] Nicholls, "Liability of Corporate Officers", *supra* note 82 at 34.

[239] Jacob S. Ziegel, "Corporate Governance and Directors' Duties to Creditors: Two Contrasting Philosophies", [2003] Ann. Rev. of Insol. L. 67 at 77.

[240] Edwards, *supra* note 22 at 9.

Thus, the purpose of defining when a corporation has entered the vicinity of insolvency is to determine when directors should become extra-vigilant in monitoring the financial affairs of the company. It is at that point that directors must strike the right balance between rebuilding equity for the shareholders and settling for maximizing value for creditors. As the corporation slides closer to insolvency or becomes insolvent, the likelihood of providing an economic return on investment to the shareholders diminishes and the role of the directors in maximizing corporate value for creditors becomes clearer. Therefore, one way for determining when directors should be put on notice to pay special attention to the situation is by using the existing statutory test for insolvency as the gauge. In this regard, the question becomes "how close is the corporation to becoming and staying insolvent"?

The *Bankruptcy and Insolvency Act* defines an "insolvent person" (which includes a corporation) as an entity who is not bankrupt, resides, carries on business or has property in Canada, whose liabilities to creditors amount to at least one thousand dollars, and:

(a) who is unable to meet his obligations generally as they come due;

(b) who has ceased paying his current obligations in the ordinary course of business as they come due; and,

(c) the aggregate of whose property is not, at fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be

sufficient to enable payment of all his obligations, due and accruing due.[241]

Under the *Bankruptcy and Insolvency Act*, an assignment or proposal may be filed by an "insolvent person"[242] and a fraudulent preference[243] by an "insolvent person" in favour of a creditor may be attacked if it was made in the three-month period prior to bankruptcy or within one year of bankruptcy if the parties are related. Further, one of the acts of bankruptcy under the *Bankruptcy and Insolvency Act* is if a person "ceases to meet his liabilities generally as they become due".[244] Therefore, there is no shortage of Canadian judicial decisions defining when a person becomes insolvent.[245]

Given the statutory test for an insolvent person, directors are given notice of what they have to watch for and they should be able to identify the risk of an approaching insolvency or when the corporation has in fact become insolvent. In essence, directors are being told to monitor cash flow, projected cash flow, and the value of assets as compared to liabilities.

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[241] *BIA*, *supra* note 228 at s. 2 "Definitions".

[242] *Ibid.* at ss. 49(1) and 50(1)(a).

[243] *Ibid.* at s. 95.

[244] *Ibid.* at s. 42(1)(j).

[245] An extensive summary of such judicial decisions may be found under the appropriate annotations for each relevant section in Lloyd W. Houlden, Geoffrey B. Morawetz and Janis P. Sarra, eds., *The 2010 Annotated Bankruptcy and Insolvency Act* (Toronto: Thomson Carswell, 2009) at paras. B25, D72, E8, and F21. Particular note is made of Justice Farley's finding in *Re Stelco Inc.* (2004), 48 C.B.R. (4th) 299 (Ont. S.C.J.[Commercial List] at para. 40, leave to appeal to Ont. C.A. refused (2004), CarswellOnt 2936 (C.A.), further leave to appeal to S.C.C. refused (2004), 338 N.R. 196 (note), that, in the context of a corporate restructuring or "rescue" under the *BIA*, *supra* note 228 or *CCAA*, *supra* note 228, the test for insolvency "would be to see whether there is a reasonably foreseeable … expectation that there is a looming liquidity condition or crisis which will result in the applicant running out of 'cash' to pay its debts as they become due … without the benefit of the stay" ordered by the court.

The law tells directors that an inability to meet liabilities as they generally become due is not a complete inability, as that would require liquidation of assets to meet liabilities thereby rendering meaningless the balance sheet insolvency test. However, it does include the situation of a corporation that cannot satisfy its obligations without liquidating assets that are not normally liquidated in the ordinary course of business.[246] It should be a sign to directors that the company is insolvent or there is a material risk of insolvency if they are contemplating liquidating assets that are not normally liquidated in the ordinary course in an effort to raise money to meet corporate obligations.

Further, many corporations rely on a revolving credit facility, such as a line of credit or an overdraft facility, from a financial institution to finance costs. In this situation, as long as the corporation is within its financial covenants and has sufficient credit at its disposal in its credit facility to pay costs, it will be able to meet its obligations generally as they come due. If the corporation is dependent on its credit facility to cover costs and the directors are aware that the corporation no longer has access to credit under its credit facility or that its "burn rate" on cash is such that it will run out of credit, then the law tells directors that the company is not able meet its liabilities generally as they come due.[247] Again, directors are given notice of a material insolvency risk.

To prove that a corporation has ceased paying its obligations generally as they come due, the usual legal procedure is to call a number of creditors who will testify that their accounts are overdue and that they have been pressing for payment without success

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[246] *Ibid.* at para. F 206 citing *Re Pac. Mobile Corp.* (1979), 32 C.B.R. (N.S.) 209 (Que. S.C.).

[247] *Ibid.* at para. F 206 citing *Re Bel Air Elec. Inc.* (1962), 3 C.B.R. (N.S.) 252 (Que. S.C.).

or with only partial success.[248] Thus, the law again has given directors clear notice of a threatened insolvency if the corporation has begun to struggle to pay its obligations that are falling due and an insolvency in fact if it has stopped paying them.

The starting point for determining the legal test of insolvency based on a corporation's assets being less than its obligations is the company's balance sheet of assets and liabilities. However, the book value that is ascribed to assets cannot be accepted at face value and such assets need to be assessed to determine their sale value "if disposed of at a fairly conducted sale under legal process".[249] Again, the law informs directors as to what they have to look out for in terms of when the recoverable value of a corporation's assets may be diminishing in value or has reached the point where the collective recoverable value is less than the corporation's debts.

By being aware of the test for an insolvent person, directors will know when the corporation is confronting a material risk of insolvency. Being unable to meet obligations coming due and ceasing to pay current liabilities are insolvency tests under the *BIA* that generally are determined by a cash-flow analysis. Not having assets sufficient in value to pay all debts is generally considered to be a balance sheet insolvency test. Thus, directors need to have a reasonable understanding of such accounting concepts and they need to keep a watchful eye on such indicators, or barometers, of financial performance. Regular and ongoing review of cash flow,

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[248] *Ibid.* at para. D 11.

[249] *Ibid.* at para. F 206 citing *Re King Petroleum Ltd.* (1978), 29 C.B.R. (N.S.) 76 (Ont. S.C.); *Re Arthur Lennox Contractors Ltd. (No. 2)* (1959), 38 C.B.R. 125 (Ont. S.C.); *Touche Ross Ltd. v. Weldwood of Canada Sales Ltd.* (1983), 48 C.B.R. (N.S.) 83; additional reasons at (1984), 49 C.B.R. (N.S.) 284 (Ont. S.C.).

projected cash flow, and balance sheets will give clear notice of a threatened insolvency disturbance. It would be a rare situation for directors to be unaware of the threat of looming insolvency or that the corporation is in a state of insolvency. If directors are having a discussion about a chronic "cash crunch" or are expressing a concern in respect of the realizable value of the corporation's assets relative to its debts, then the corporation is likely in the vicinity of insolvency.[250]

Directors who are doing their job properly receive notice or warning of a developing insolvency and know when it has matured into a state of insolvency. As such, the "notice problem" as to when directors should shift to managing the business and affairs of the corporation primarily in the best interests of the creditors is arguably not a problem at all. The shift should occur when the risk of insolvency is serious or material. What is a serious or material risk of insolvency is one that requires significant counteractive measures.

Further, we should not shy away from identifying a material risk of insolvency, thereby giving legal meaning to the concept vicinity of insolvency, because it can be identified by using the standard legal objective test. One of the principles of our legal system is the standard of the reasonable person, to be objectively determined. We have no problem, for example, assessing the impugned actions of directors for whether they acted as is expected of a reasonable director under the business judgment rule or in evaluating whether, in a negligence action, the defendant used reasonable care so as not to harm the plaintiff. As such, the legal objective test can be applied to determine vicinity of insolvency. The more important question for directors is how will they

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[250] Edwards, *supra* note 22 at 9.

respond. Based on a shareholder primacy model of corporate decision-making, the answer is that directors will take reasonable steps in the circumstances to do what is required to maximize corporate value and not dissipate it. What will trigger this response is a material risk of insolvency, being one the requires significant counteractive measures, to be objectively determined.

The irony of directors having notice of a pending insolvency is that such notice also may give rise to an incentive on the part of directors to prefer their conflicting interests over those of the creditors. The following are some examples of when directors' and creditors' interests may conflict.

(a) When directors are also shareholders. Directors may have an incentive to pursue riskier restructuring opportunities in an attempt to recover their lost investments. In that case, directors would not be governing with a view to maximizing corporate value for creditors. In addition, directors may buy additional time to pursue riskier restructuring opportunities by ordering goods or services or accessing credit for which they know the corporation will be unable to pay unless the directors' gamble pays off.

(b) When directors are concerned about their reputations. Directors would not want to be seen as having managed a company into financial distress. To avoid this perception, there may be an incentive to pursue riskier restructuring opportunities in an effort to salvage a good managerial reputation. Like the situation in subparagraph (a), directors would not be governing in the interests of the creditors and may increase the level of

corporate debt if and when riskier turn-around opportunities do not prove successful.

(c) When directors have personal guarantees to secured creditors, there may be an incentive to purchase goods from unsecured trade creditors, knowing that the corporation is unlikely to be able to pay for them. This would be done in order to increase the value of the secured party's collateral, thereby decreasing the exposure on the personal guarantees.

The forgoing incentives for directors to pursue their self-interests must be deterred if corporate value is to be maximized for the greatest number in a situation of financial distress or insolvency. The oppression remedy is an effective deterrent. Creditors may qualify as "complainants" and the court has a discretion to fashion a legal remedy to address any oppression of the creditors', resulting from their reasonable expectations not being met in the circumstances. One such legal remedy is judgment against directors personally.

In addition to the oppression remedy, creditors also may seek leave of the court to bring an action on behalf of the corporation against directors for negligence and on the basis of a breach of a director's duty to act honestly and in good faith in the best interests of the corporation. A judgment for these causes of action would be awarded in favour of the corporation, but this judgment would be used by the corporation to satisfy its debts and liabilities.

Creditors have an incentive to commence legal proceedings as these legal remedies are easily accessible and powerful and give rise to personal liability on the part of directors. They are an effective deterrent.

The examination in this chapter of whether vicinity of insolvency is capable of legal definition completes the analysis in this thesis of the corporate decision making models under review. A case study is presented in the following chapter to allow for a better understanding of the application of the legal theories and concepts which have been considered in this thesis.

CHAPTER 9

CASE STUDY

The following factual scenario may help illustrate the operation of the competing decision-making models.[251] A steel supplier is seeking to have the directors held personally liable for the corporation's unpaid steel purchase. The debtor is a small, closely-held corporation. It manufactures steel hinges for use in automobiles. The debtor's most significant customer also was a supplier of automobile parts. Approximately ninety percent of the debtor's business was with this one customer. The customer would buy hinges from the debtor and incorporate the hinges into a product that it would manufacture for, and sell to, automobile manufacturers. At all times, the debtor had a substantial unsecured running account with this customer, which the customer regularly paid during the second week of each month.

In order to carry on business, the debtor had:

(a) a line of credit and equipment loans with a bank;

(b) outstanding shareholder loans for amounts of money that shareholders advanced over the years for working capital purposes;

(c) a commercial lease with a landlord for a manufacturing facility;

[251] This factual scenario is based on a file on which I am currently working. I represent the directors of a bankrupt corporation, who are defending against a claim by the corporation's unpaid steel supplier. The supplier is attempting to hold the directors personally liable on the basis of alleged fraudulent conduct for unpaid steel that it supplied to the corporation.

(d) employment contracts with labourers to produce the hinges, with drivers to deliver the hinges to its customers, with salespeople, and with office staff;

(e) unsecured suppliers of goods and services; and,

(f) remittances to the government for Goods and Services Tax payable and in respect of amounts that were required to be deducted from employees' pay for personal income tax, unemployment insurance, and Canada Pension Plan contributions.

The debtor relied on its line of credit with its bank, receipt of the monthly payment from its one major customer, and payment from the balance of its customers in order to have the money to pay its ongoing corporate obligations. On a monthly basis, the directors of the debtor reviewed historical cash flow and prepared cash flow projections to ensure that the debtor would have a sufficient incoming stream of cash, from sales or its line of credit, to pay all of the corporation's obligations that were coming due. The debtor could not meet all of its obligations without the monthly receipt of payment from its one major customer. For the past several years, the debtor showed a modest profit and the value of its assets was more or less equal to its debts on its year-end audited financial statements.

On May 1, 2008, the debtor ordered an amount of steel, which was to be delivered in three shipments on June 14 and 24 and July 14, 2008. The total price of the steel was $150,000. The purchase price was to be invoiced at the time of each shipment, each in the amount of $50,000. At the time of shipment, a cheque for this amount of money was

to be provided to the supplier, post-dated for thirty days from the date of the invoice. The first delivery was made on June 14 and a cheque, post-dated to July 15, was provided. The second shipment was made on June 24 and a cheque, post-dated to July 25, was provided.

On July 8, the directors learned that its major customer had filed for bankruptcy protection in both the United States and Canada. This caused the directors significant concern because, without the July payment from the customer, the debtor would not be able to pay all of its obligations coming due and, without future supply orders from this customer, the debtor's business would fail. However, the directors did not feel that significant corporate turnaround, or "rescue", measures were warranted because of subsequent assurances made by the customer supported by the customer's conduct.

On July 10, the directors met a representative of the customer, who was in charge of purchasing, and the purchasing agent, who was in charge of the customer's account with the debtor. The directors were assured that the customer planned to stay in business, that the receivable that was due to the debtor for July would be paid, and that the debtor and the customer would continue to do business, as the debtor was a critical supplier to the customer. At the meeting between the debtor and the customer, the timing of supply of pending orders and a possible business expansion also were discussed. Subsequent to the meeting, discussions in this regard continued.

On July 14, the steel supplier delivered the third steel shipment and the debtor provided a cheque, post-dated to August 15. Shortly after this steel shipment arrived, the debtor's driver returned from a delivery to the customer and advised the directors that the

customer's employees had been told that the customer was closing its doors, that the employees had been sent home, and that the customer's machinery and equipment were being removed from the plant. With the closing of the customer's business, the directors appreciated the risk that the July receivable would not be paid had dramatically increased, meaning that the debtor would not be able to pay all of its liabilities that were coming due, and that the debtor would lose all of its future business with this customer, meaning that its own business would fail.

The directors recognized that, unless they could rescue the corporation, it would fail. They needed to determine whether there were measures that could be implemented to turn around the debtor's financial situation, failing which an orderly liquidation of the debtor's assets would have to be conducted. The directors appreciated that if the debtor downsized its workforce and did not pay its steel supplier, then it would have enough credit in the line of credit that was available to it and projected cash from the balance of its customers to operate for one month. In particular, for this short period of time, the debtor would have enough money to make the interest payments on its line of credit and its equipment loan in order to keep its banker from taking steps to realize its security, to pay its landlord in order to prevent a distraint, to pay a core group of employees in order to maintain a minimum level of production, and to make all payments that were required to be made to the government for source deductions and Goods and Services Tax, but that, in so doing, it would not be able to honour the post-dated cheques to the steel supplier that were coming due.

The directors also realized that the only long-term hope for the debtor was if it could replace the lost future business with the customer by entering into new

arrangements with competitors of the customer that had taken over the customer's contracts with the automobile manufacturers. The directors, as shareholders, were prepared to loan additional working capital money to the debtor to make up for the loss of the July receivable from the customer if the directors believed that the loss of the future business could be replaced. In other words, the shareholders were prepared to loan further money to the debtor for working capital purposes to replace the loss of the July receivable if they felt confident that the debtor had a future. The directors also recognized that, in order to pursue replacing the lost business with the customer, they had to use the last unpaid shipment of steel that had been delivered by the steel supplier in order to have product to offer.

Pursuing turn-around measures in these circumstances would require laying off some workers, putting a stop payment on the post-dated cheques to the steel supplier, processing the last shipment of steel that had been delivered but not paid for, pursuing opportunities for replacing the lost business, and, if these turned out to be promising, then having the shareholders advance working capital to the debtor to cover the sizeable receivable that the corporation had lost from its major customer. The company could then continue as a going concern enterprise. Additionally, any new supply of materials would have to be on a cash-on-delivery basis until the debtor had re-established its credit.

It was estimated that, in a liquidation scenario, there would be sufficient proceeds to pay all claims that were secured by statutory deemed trusts or liens and all secured claims, with surplus money remaining to make partial payment to the unsecured creditors, including the shareholders on account of their loans. Thus, any liquidation would have to be done by way of bankruptcy in order to have a process to distribute the

surplus funds to the unsecured creditors on a *pro rata* basis. A bankruptcy also would be necessary for a liquidation in order to take advantage of the trustee in bankruptcy's right to have possession of the leased premises for ninety days to allow the liquidation to take place from the leased premises.

Pursuing the turn-around strategy would jeopardize the *pro rata* amount that the unsecured creditors would receive in a bankruptcy liquidation. However, if successful, the turn-around strategy would result in the unsecured creditors getting paid in full, albeit over time, and the shareholders eventually recovering their shareholder loan investments. It also would mean the continuation of employment for a number of people, an ongoing rental income stream for the landlord, and payment of government claims, which money is used to fund government programs. The directors reasonably believed that the debtor would be able to enter into contracts with the entities that had picked up the customer's work with the automobile manufacturers. This confidence was based on the facts that the debtor had a good supply history with its major customer and was set up with the tools, dies, and machines to manufacture hinges to the specifications that were required by the automobile manufacturers. However, the debtor's major customer had been situated one hour away from the debtor by highway, whereas these new potential customers were considerably further from the debtor. Thus, timely shipment might prove to be too costly and a logistical problem. The directors assessed the likelihood of being able to make up the corporation's lost business at a little better than even odds. What should the directors have done in these circumstances?

A pluralistic definition of what it means to act in the best interests of the corporation would require the directors, in their decision-making process, to consider,

balance, and treat fairly all affected stakeholders. That characterization provides directors with no guidance as to how to go forward. Directors are not given any direction as to what they need to do to satisfactorily determine the interests of the stakeholders. No thought has been given to the practical problem that would result for directors upon canvassing stakeholders to ascertain their interests. A time consuming consultative process may arise paralyzing decision making or creating delay and inaction when directors are required to act quickly. Directors are not given any criteria to use to determine priorities among stakeholders. Directors are not given any direction or explanation as to how much weight to give to stakeholder interests. Directors are not given any direction as to what it means to treat stakeholders fairly.

A decision-making model that is based on maximization of corporate value is an action based model. It would tell the directors that they should pursue the opportunity for lost business and, thus, take measures to keep the company alive and operating as a going concern by laying off some of the employees, not paying the steel supplier, and processing the last shipment of steel, if replacing the lost business was realistic and reasonably likely, thereby satisfying the economic interests of all stakeholders. If replacing the lost business was not realistic and reasonably likely, then corporate value maximization would require a cessation of business and a liquidation in order to preserve and not squander the existing value of the corporation, thereby satisfying the economic interests of the most classes of stakeholders. The shareholder primacy model provides a clearer and more concise mandate for directors.

The oppression remedy would apply to ensure that, in their decision, the directors do not oppress the steel supplier or other creditors by not protecting their reasonable

expectations. The overriding consideration in this regard would be that there was an element of risk of non-payment that was assumed by the steel supplier and other creditors in dealing with the debtor on an unsecured basis. Furthermore, our market system dictates that this risk is not stagnant but is fluid and that, as such, future financial distress was a foreseeable consequence of doing business with the debtor. This foreseeable consequence of an increased credit risk is acknowledged by the standard practice of unsecured creditors to keep tabs on the aging and collection of their accounts receivable. This monitoring is done in order to assess, on an ongoing basis, any increased risk of non-payment. Lastly, the steel supplier and the creditors in general would likely be aware of the existence of statutory personal liability that is imposed on directors for corporate debts, which is intended to make payment of these corporate debts a priority. For example, it can be assumed that creditors are aware, when entering into contracts with debtors, that statutory personal liability for unpaid wages and vacation pay to employees or for unremitted source deductions to Canada Revenue Agency will result in directors giving priority to payment of these claims over the claims of unsecured creditors. As such, it would not be reasonable for the steel supplier or other unsecured creditors to expect payment in full in priority to corporate claims for which the directors have personal liability in circumstances of financial distress. What the steel supplier and other creditors are entitled to reasonably expect is that the directors will take measures, if realistic and reasonable, to maintain the debtor as a going concern business for the good of the greatest number of stakeholders, without engaging in fraud, deceit, and negligent or fraudulent misrepresentations. In addition, they are entitled to reasonably expect that if it is not realistic and reasonable to maintain the debtor as a going concern business for

the greatest number of stakeholders, then the directors will liquidate the debtor's assets in order to preserve value.

The difference between the operation of the pluralistic model and the shareholder primacy model in this fact scenario is that:

(a) the pluralistic model allows for a broader range of interests to influence corporate decision making while the shareholder primacy model does not;

(b) the corollary of this is that the shareholder primacy model allows for determining a strategy for acting in the best interests of the corporation solely from the corporation's perspective of what measures would maximize corporate value for as many classes as stakeholders as possible; and,

(c) thus, the maximization of corporate value concept is a more efficient and expeditious one in the pressing circumstances created by financial distress.

The factual scenario that was outlined above was based on an existing set of facts. The decision that was made by the directors was to proceed with the turn-around strategy. The debtor entered into some replacement contracts, the shareholders advanced more money, and the debtor continued in business. The debtor entered into a settlement agreement with the steel supplier to repay in monthly instalments the amount that owed and it continued making payments to all of its other unsecured creditors. However, in early 2009, the automobile manufacturers themselves began experiencing financial difficulty, resulting in a significant reduction in demand for hinges. This situation

considerably reduced the debtor's sales and future prospects. The end result was that the debtor could not generate a sufficient revenue stream to pay all of its obligations. Approximately one year after the debtor learned of the demise of its major customer, it made an assignment in bankruptcy. The unsecured creditors and the aggregate amount that was owed to them did not change substantially from the time at which the debtor learned of the demise of its major customer to the time of bankruptcy one year later. However, in the bankruptcy, there were no surplus proceeds available for the unsecured creditors, including in respect of the shareholder loans. Thus, in hindsight, the general body of unsecured creditors would have been better served with a bankruptcy liquidation one year earlier. Ironically, the steel supplier received more than it would have recovered in a bankruptcy one year earlier as a result of the settlement payments that were made as part of the restructuring. Also, the shareholders lost the additional money that they had advanced to the company as part of the restructuring.

If the turn-around strategy had succeeded, then it would have benefited all stakeholders who were economically dependent on the corporation and their economic dependents. Regardless of the negative end result, the real-life scenario highlights two important points that arise from the corporate value maximization principle. First, under the maximization of corporate value model, the clear focus is always on economically benefitting the greatest number of stakeholder classes and the economy in general, whereas, under the pluralistic model, the focus is ambiguous. Second, the functioning of our free market economic system is based on entrepreneurial risk-taking and such risk-taking is encouraged under the principle of maximization of corporate value, as long as it is based on sound business judgment.

CHAPTER 10

CONCLUSION

With the exception of not-for-profit corporations, they are incorporated generally with a view to carrying on business for the purpose of being profitable and generating wealth. In simple terms, this means generating revenues that exceed expenses and having assets that are of greater value than debts and liabilities. This is what is meant by "maximizing corporate value". It is the *raison d'être* of a corporation. This economic motivation is consistent with the best interests of a corporation's stakeholders. Striving to maximize corporate value in this way, based on the shareholder primacy model, will ensure that the economic interests of all classes of stakeholders, or at least the greatest number of them, are satisfied. To reiterate the Supreme Court of Canada's observation, "[t]he interests of shareholders, those of creditors and those of the corporation will be consistent with each other if the corporation is profitable and well capitalized and has strong prospects".[252]

The "maximization of corporate value" rule, upon which the shareholder primacy model is premised, should not be taken to be the antithesis of pluralism. When considered in context, there is a certain amount of pluralism within the principle of maximization of corporate value. In particular three contextual factors are to be emphasized. First, the pursuit of the maximization of corporate value principle is

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[252] *SCC Peoples, supra* note 21 at paras. 44-45..

governed by corporate laws. The oppression remedy is one example of how corporate law affects the pursuit of the principle in a pluralistic manner. Second, as the Delaware Court of Chancery said, the "realities, of course, do not mean that directors are required to put aside any consideration of other constituencies…when deciding how to manage the firm" and they may consider the interests of non-shareholder stakeholders, but as long as they "are primarily focused on generating economic returns…in order to deliver a return to the company's shareholders who…agreed to bear the residual risk associated with the firm's operations".[253] In other words, the reality of managing a corporation is that non-shareholder interests may be relevant to maximizing corporate value, especially over the long run. Third, to quote Winkler again, "the actual decision making of corporate officers is heavily constrained by legal rules from outside of corporate law… [o]ne must take into account environmental law, labour law, civil rights law, workplace safety law, and pension law, lest one be left with the distorted and incomplete view of how the law actually shapes those corporate decision matrices".[254] These additional "legal rules from outside of corporate law" would include, as touched upon in this paper but not forming an integral part of the analysis, certain causes of action arising under common law and equity, such as misrepresentation and fraud. This constraint that is placed on the shareholder primacy model by "legal rules from outside of corporate law" is accomplished by imposing personal liability on directors.

A fundamental problem with the pluralistic corporate decision-making model is that it is not a well-defined concept and may be too ambiguous to have any practical

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[253] *Production Resources, supra* note 140 at 787.

[254] Adam Winkler, "Corporate Law", *supra* note 19 at 133.

significance for directors. The Supreme Court of Canada mandates directors, in discharging their duties to act in the best interests of the corporation, to strive to create a "better corporation" or to have the corporation act as a "good corporate citizen" by treating fairly all affected stakeholder interests. This is to be contrasted with the economic focus of the shareholder primacy model, which is consistent with the corporation's *raison d'être*. To manage the corporation such that revenues exceed expenses and asset values exceed debt loads is a much clearer and direct mandate for directors to follow than is trying to create a "better corporation" or have the corporation act as a "good corporate citizen". By having a clearer understanding of their mandate, directors will know their boundaries and will not be deterred from taking appropriate entrepreneurial risk by the threat of personal liability that is created by uncertain boundaries.

From a practical perspective, the question of what it means to act in the best interests of the corporation becomes of greater relevance when a corporation experiences financial distress or is insolvent. When directors are not able to satisfy the economic interests of all stakeholders with the economic resources at their disposal, their decision-making becomes markedly more difficult and they will be faced generally with the following two basic questions:

(a) what measures, if any, can be implemented to return the corporation to profitability and a positive balance sheet; and,

(b) at what point in time should the corporation be wound up and liquidated to preserve the value of the corporation's assets if there is no reasonable likelihood of it continuing as a going concern?

Directors are most in need of guidance and direction in how to manage the business and affairs of the corporation when they are met with these two questions arising outside of the ordinary course of business.

A model of corporate decision-making that is based on economic considerations, as opposed to one requiring a balancing of affected stakeholder interests, provides the guidance that directors require in situations of financial distress or insolvency when competing interests arise. The residual beneficiary basis for the shareholder primacy model supports a creditor primacy model when the corporation enters the "vicinity of insolvency" or is insolvent. The shareholder primacy model works to the benefit of all stakeholder classes because, under it, the economic interests of all stakeholder classes must be satisfied before the shareholders' economic interests can be satisfied. When the shareholders appear likely to have lost their investment, because the corporation is in the "vicinity of insolvency" or is insolvent, they become displaced by the general body of creditors as the residual beneficiaries. In other words, by requiring directors to maximize corporate value for the general body of creditors, rather than for the shareholders who have likely lost their investment, corporate value is maximized for all of the non-shareholder classes of stakeholders that have not yet lost their economic interest in the corporation. This approach favours directors trying to maintain the corporate entity as a going concern, as it would have more economic value as a going concern than on a liquidation basis. Thus, the creditor primacy model meets the public policy objective of

striving to turn around and maintain as a going concern enterprise a corporation that is in financial trouble, if possible.

A "shift" to a creditor primacy model also would result in a more efficient use of economic resources. Directors would not be required to make "high risk, high yield" decisions with a view to recouping value for the shareholders but likely resulting in a further diminution in corporate value. Moreover, being prudent so as to, at a minimum, preserve corporate value would seem to be consistent with the concept of a corporation being a separate legal entity that is incorporated for the purpose of accumulating wealth. A corporation that maintains some corporate value is a better corporation than one with no remaining value.

As for when the "shift" to a creditor primacy model should take place, directors will know when the corporation has crossed the line and is faced with a material risk of insolvency, defined in Chapter 8 as when the risk of insolvency becomes serious and significant counteractive measures need to be taken to turn the corporation's financial situation around. The existence of a material risk of insolvency can be determined objectively, with protection being afforded to directors under the business judgment rule. It is important for directors to be cognisant of an approaching insolvency so as to adopt the appropriate strategy that has the best chance of turning around the corporation's financial situation and not a high-risk strategy that is designed to recapture shareholder equity.

In the final analysis, the corporation and all of its stakeholders are better served by the corporation focusing primarily on maximization of corporate value within the

constraints that are imposed by corporate law, the reality that the interests of all non-shareholder stakeholders may be relevant to maximizing corporate value, and the law outside of corporate law affected directorial behaviour. This mandate did not need to be disturbed to provide for more emphasis on non-shareholder stakeholders and less emphasis on the economic purpose of a corporation.

The existence of the business judgment rule is important. It could be argued that it really does not matter which decision-making model is to be applied since the business judgment rule significantly weakens or undermines any model. This argument would be based on the protection that is afforded to directors under the business judgment rule. However, such an argument is superficial and cannot be supported for two reasons. First, as demonstrated in Chapter 7 above, a proper application of the business judgment rule holds directors accountable under the governing decision-making model, meaning that directors must properly inform themselves of the relevant facts, they must act honestly and in good faith, and they must make a decision that is among the reasonable alternatives available. Second, it, therefore, matters which decision-making mandate is to be applied as it sets out the rules and principles against which directors are to be judged to determine accountability. The starting point is to consider what the director's mandate was and then to determine if this mandate was exercised using sound business judgment.

In conclusion, a corporate law, or accountability, for what it means to act in the best interests of the corporation based on the shareholder primacy model may be stated as follows.

(a) Directors have a primary duty to act in the best interests of the corporation.

(b) This duty means maximizing corporate value.

(c) The maximization of corporate value is qualified in three respects. First, it must be pursued according to corporate law. Second, the interests of any stakeholder may be considered if relevant to maximizing corporate value. Third, in maximizing corporate value, directors are to act in accordance with the laws outside of corporate law that govern corporate behaviour.

(d) Any conflict between what is determined to be in the best interests of the corporation and a stakeholder interest must be resolved in favour of the corporation.

(e) In making decisions, directors are to take reasonable steps to inform themselves, they are to act honestly and in good faith, and their decision must come within a range of reasonable alternatives. As long as these conditions are met, the exercise of a director's judgment will not be disturbed.

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