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Directors' Liability: What does the Supreme Court of Canada think?

Introduction

Seldom do we have the highest court in the land deal with corporate matters, so the recent decision of *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461, 2004 SCC 68, evoked great interest. In a controversial decision, the Supreme Court of Canada exonerated the directors of a bankrupt corporation from all liability with regard to its creditors for losses resulting from decisions made before the bankruptcy.

Our purpose here is to summarily review the judgment and examine what the Supreme Court has to say about a director's fundamental duties: fiduciary duty and duty of care. The issue in particular is whether directors owe a duty to creditors. (For the judgment in its entirety, [click here](#).)

Background

Wise Stores Inc. ("Wise") acquired Peoples Department Stores Inc. ("Peoples") from Marks & Spencer Canada Inc. ("M & S"). Because of the agreement with M & S, Peoples could not be merged with Wise until the purchase price had been fully paid to M & S. The three Wise brothers were majority shareholders, directors and officers of Wise, and became sole directors of Peoples. From the outset, the joint operations of Wise and Peoples did not go smoothly. Parallel bookkeeping and shared warehousing arrangements caused serious administrative and inventory problems.

In an attempt to resolve the problems, the Wise brothers agreed to implement a joint inventory procurement policy whereby the two companies would divide responsibility for purchasing. Peoples would make all purchases from North American suppliers and Wise would make all purchases from overseas suppliers. Peoples would then transfer to Wise what it had purchased for Wise, charging Wise accordingly, and vice versa. This new policy did not sit well with M & S because it would ultimately cause Peoples to finance Wise as Wise's indebtedness to Peoples increased by millions of dollars. In addition, Peoples' retail business was lagging as competition from other retailers became strong. Shortly thereafter, both companies declared bankruptcy.

Peoples' trustee filed a petition against the Wise brothers. The trustee claimed that the Wise brothers were in breach of their duties as directors under s. 122(1) of the *Canada Business Corporations Act* ("CBCA") by favouring

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the interests of Wise to the detriment of Peoples' creditors.

The trial judge found the Wise brothers liable and concluded that by implementing the new policy Peoples' directors breached their duties to the company and its creditors. The Quebec Court of Appeal set aside the trial judge's decision and sided with the directors. The trustee appealed to the Supreme Court.

Supreme Court decision

The Supreme Court dismissed the appeal and concluded that the directors of Peoples did not violate either their fiduciary duty or their duty of care under s. 122(1) CBCA. The two duties are distinct and designed to secure different ends; the Supreme Court addressed each separately.

1) Fiduciary Duty (s. 122 (1)(a) CBCA)

The fiduciary duty imposes upon a director the obligation to act honestly and in good faith with a view to the best interests of the corporation. In light of the evidence of a desire to make both Wise and Peoples "better" corporations, and in the absence of fraud or personal benefit, there was no breach. The directors implemented the new policy with a view to solve the serious inventory management problem, and acted honestly and in good faith. The fact that the policy was not successful, does not qualify it as a breach even if the corporation was on the verge of insolvency. Moreover, the directors owe their fiduciary obligation to the corporation and the corporation's interests are not to be confused with the interests of the creditors. The fiduciary duty does not extend to the creditors given the availability of an oppression remedy or a claim based on the duty of care.

2) Duty of Care (s. 122 (1)(b) CBCA)

The duty of care requires a director, in managing the corporation's affairs, to exercise care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. While the beneficiary of the duty of care includes creditors, directors will not be liable if they act prudently and on a reasonable informed basis. The Supreme Court raised the duty of care to an "objective standard" in which circumstances, such as socio-economic conditions, surrounding the actions of the directors are important and should be taken into consideration. In light of all the circumstances, the policy was a "reasonable business decision" made by the directors, and therefore, they did not breach their duty of care in respect of the creditors of Peoples. What's more, the trial judge erred in concluding that the policy led to Peoples' demise. Other important factors, such as Wal-Mart's arrival in Canada, contributed more directly to Peoples' bankruptcy.

Conclusion

The Supreme Court has set guidelines for directors to follow in respect of their duties. They must respect the trust and confidence placed in them to manage the corporation. In doing so, they must avoid conflicts of interests with the corporation and avoid abusing their position for personal gain.

In this era of corporate scandals, directors of corporations across Canada are letting out a huge collective sigh of relief in knowing that perfection is not demanded of them when making their business decisions. Provided they choose a solution that falls within the range of reasonableness, directors are not to be second-guessed by the courts, unless there is evidence they rejected an alternative that was clearly more beneficial to the corporation. Ultimately, the Wise brothers were exonerated for their arguably "bad" decision because it was made in an attempt to rectify a serious business problem in circumstances in which no solution may have been possible.

If you would like to learn more about liability of directors of an insolvent corporation in light of the Supreme Court ruling in the *Peoples* case, Mr. Paul Martel, attorney and author, will tackle this issue at the "Congrès du Barreau" hosted by the Quebec Bar Association to be held on June 2, 3 and 4 in Gatineau, Quebec. For more information on the conference, please [click](#)

training session. For more information or to schedule a training session, please call Annie Fredette at 514-861-2799, ext. 355, or contact her by email at afredette@crac.com

[here.](#)



Seminar on Corporate Names

In answer to our clients' interest regarding name searches, CRAC's own, Denis Livernoche (see photo), Supervisor of the name searches department, gave a seminar on corporate names on May 31, 2005.



Corporations Canada's Annual Meeting [back](#)

Last April 28, Corporations Canada once again held its annual Client Information Session in Montreal. The meeting is intended to bring clients and staff members of Corporations Canada together to discuss and review various topics. Obviously, we cannot report on all the topics discussed during the meeting but we have summarized the following four points:

a) Service Delivery Problems

This was one of the more pressing items on the agenda since clients always want to know when will they receive their certificates? Two main reasons were given for delays in the services: 1) volume being on the rise with respect to filings and name decision requests; and 2) staff turnover being high and retraining of new staff taking time. Their challenge for the upcoming year will be to maintain their service delivery standards by providing speedy and efficient service to clients.

You may check out Corporations Canada's delays - as well as the Registrar's - with respect to issuance of certificates and other documents by visiting CRAC's website. The list on our website is updated each week and we monitor the situation closely to keep you informed of any changes. To

see the latest service delays, [click here](#).

b) Update on Bill C-21

The latest news on the much-anticipated Bill C-21, *An Act Respecting Non-Profit Corporations*, is that it was tabled again in November 2004 before Parliament (it died when the last federal election was called) and has recently passed the first reading stage before the House Committee. The second and third readings of the Bill remain and then on to the Senate for royal assent. Of course, if another federal election is called before the Senate's royal assent, they will have to start the whole process over again.

c) Annual Return Date

You may recall that a corporation was required to file its annual return within 60 days from the anniversary date before it was changed a few years ago to 6 months from the financial year-end. They may decide eventually to go back to the rule of the anniversary date because Strategis is somewhat lacking in terms of financial information that Canada Revenue Agency refuses to release to Corporations Canada for reasons of confidentiality (e.g.: date of financial year-end). This change would simply require an amendment to the regulations of the CBCA. Corporations Canada is asking for comments from clients before they proceed with such change, which will not take place before perhaps another year.

d) Changes to Forms 1, 4 & 15

Corporations Canada intends to issue new Forms 1, 4 and 15. We were given a sample of these forms in English and French and were invited to make comments or suggestions. The biggest change happens to be on the articles of revival - Form 15 – with a view to simplify it, and thus, alleviate the high rejection rate. Insufficient space on these forms was the most common complaint by those in attendance. No date has been set yet for the coming into effect of the new forms. We will keep you posted.

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