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From *Production Resources* to *Peoples Department Stores:* A Similar Response by Delaware and Canadian Courts on the Fiduciary Duties of Directors to Creditors of Insolvent Companies**

IN THE CURRENT ENVIRONMENT OF INCREASING SCRUTINY of corporate behavior after corporate scandals such as Enron and WorldCom,[1] lawsuits brought by creditors or bankruptcy trustees against officers and directors have become more common.[2] The suits are taking center stage, particularly on the dockets of courts in the United States, and are receiving much public attention.

Against this backdrop, two prominent courts—the Supreme Court of Canada and the Delaware Court of Chancery—issued widely influential opinions within

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** This article, originally published in the *Annual Review of Insolvency Law*, was written in 2005 in anticipation of the *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies* conference at the University of Maryland School of Law. Since that time, the Delaware Court of Chancery has addressed the issue of fiduciary duties of directors of insolvent companies or nearly insolvent companies, or the related issue of deepening insolvency, three times. *See* Trenwick Am. Litig. Trust v. Ernst & Young L.L.P., 906 A.2d 168 (Del. Ch. 2006); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, No. Civ.A. 1456-N, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006); Big Lot Stores, Inc. v. Bain Capital Fund VII, LLC, No. Civ.A. 1081-N, 2006 WL 846121 (Del. Ch. Mar. 28, 2006). Additionally, federal bankruptcy courts have continued to address these issues, including the Delaware bankruptcy court. *See* Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (*In re* Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006). These new cases help to flesh out the concepts expressed in *Production Resources* and related authorities, rather than fundamentally altering the state of the law.

Moreover, as this article was going to press, the Delaware Supreme Court issued its first opinion on this area of law, *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, No. 521, 2006, 2007 WL 1453705 (Del. May 18, 2007). For the most part, *North American Catholic* embraces the Court of Chancery's formulations of the duties of directors set forth in *Production Resources* and described below. However, the Delaware Supreme Court does appear to have disagreed, to a certain extent, with *Production Resources* with respect to certain concepts. Because *North American Catholic* was issued just prior to this article going to print, those distinctions are not set forth in the article that appears below.

1. *See, e.g.*, Lawrence A. Hamermesh & A. Gilchrest Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 866 (2005).

2. *See* Sabin Willet, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 549 (2005).

one month of each other on whether and to what extent officers and directors of an insolvent corporation owe fiduciary duties to creditors. Despite (or perhaps because of, and in an effort to rein in) the increasing frequency of such suits, both courts held that the concept of fiduciary duty law should not be used to "fill gaps [in the protection of creditors] that do not exist."[3]

This Article examines in detail the facts of the *Production Resources* and *Peoples Department Stores* cases and the statutory and legal frameworks in Delaware and Canada. It then examines each court's analysis of the issues of fiduciary duty, duty of care, the business judgment rule, the effect of insolvency of the corporation, and the available remedies for creditors. It notes the striking similarity in the courts' approaches to these issues. Specifically, it notes that where a corporation becomes insolvent, the directors' primary duty remains to the corporation itself, just as it did when the company was solvent. But the primary constituencies whose interests are at stake obviously changes—a factor that directors must take into account in making good-faith business decisions. It considers whether the decisions in *Production Resources* and *Peoples Department Stores* have opened or closed the gap on creditor claims against directors and, in such landscape, what advice may be offered to directors and officers of Delaware and Canadian corporations as to how to operate an insolvent company and make business decisions given the competing interests of stockholders and creditors.

The decisions in *Production Resources* and *Peoples Department Stores* followed inconsistent lower court decisions in Canada, varied results in U.S. courts, and much academic commentary as to the scope of director duties and what is appropriate in our societies. Corporate governance is at the heart of the debate as to the appropriate scope of fiduciary obligations of directors. Statutes in Canada and common law in the United States and Canada require directors to act in the best interests of the corporation. While the corporation is solvent, that "best interest" has been viewed as the best interests of the shareholders, who hold the residual interest.

Where the corporation has become insolvent, shareholder equity may have minimal or no value. The residual interest in an insolvency lies with the creditors. To what extent do director duties shift or expand in an insolvency to recognize the shift in the residual economic interest? Both the Delaware Court of Chancery and the Supreme Court of Canada have determined that there is no fundamental shift in director duties.

Indeed, notwithstanding that the statutory and/or common law frameworks for Canadian and Delaware corporations differ in certain material respects, the Supreme Court of Canada and the Delaware Court of Chancery used remarkably similar language in rendering their opinions. For example, both courts recognized

3. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 790 (Del. Ch. 2004); *see also* Peoples Dep't Stores Inc. (Trustee of) v. Wise (*In re* Peoples Dep't Stores Inc.), [2004] 3 S.C.R. 461, 486.

(i) that what is in the "'best interests of the corporation' should be read not simply as the 'best interests of the shareholders,'" but that "[f]rom an economic perspective, the 'best interests of the corporation' means the maximization of the value of the corporation";[4] (ii) that the changing economic fortunes of a company often alter what is in the best interests of the corporate enterprise;[5] (iii) that as a result of their becoming the residual risk bearers of the insolvent corporate enterprise, creditors have remedies through either oppression claims in Canada or derivative fiduciary duty claims in Canada and Delaware, and the arsenal of fraudulent preference and conveyance claims;[6] (iv) that the nature or content of directors' duties do *not* change when a company enters the nebulous "zone of insolvency";[7] and (v) that fiduciary duty law should not be used to fill in nonexistent gaps where other, existing laws already protect creditors.[8]

The holdings of these two cases differ in a technical sense, with the Delaware Court of Chancery reiterating that fiduciary duties are owed to creditors as well as shareholders and the Supreme Court of Canada holding that no such fiduciary duties are owed to the creditors. The Supreme Court of Canada recognized a duty of loyalty, if not fiduciary duty to creditors. Both courts, however, emphasized that the primary duty is owed to the corporate enterprise itself and recognized that upon insolvency, what is in the best interest of the enterprise might change, as does the identity of the residual risk bearers, from the shareholders to the creditors, but the duty itself does not shift away from the corporation. Thus, it is unclear from a practical standpoint that there is much of a real distinction in the two courts' holdings, or in the practical advice lawyers should give directors of Canadian and Delaware corporations in the aftermath of *Peoples Department Stores* and *Production Resources.*

That in itself is a welcome development, given that so many entities have both Delaware corporations and corporations organized in Canada in their family trees. Delaware has been and continues to be a leading forum in the United States for reorganizations of insolvent companies, and an increasing number of cross-border insolvencies involve Delaware and Canadian businesses and operations. Advice to directors of North American enterprises will have some consistency.

I. PRODUCTION RESOURCES: THE DELAWARE COURT OF CHANCERY'S MOST RECENT PRONOUNCEMENT OF THE ISSUE

The Delaware Court of Chancery's November 2004 opinion in *Production Resources* is likely the most important pronouncement on the nature of fiduciary duty claims brought by creditors since the Court of Chancery's 1991 opinion in *Credit Lyonnais*

4. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 481; *accord Prod. Res. Group, L.L.C.*, 863 A.2d at 791.
5. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 482; *Prod. Res. Group, L.L.C.*, 863 A.2d at 788.
6. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 484–85; *Prod. Res. Group, L.L.C.*, 863 A.2d at 792.
7. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 483; *Prod. Res. Group, L.L.C.*, 863 A.2d at 790 n.56.
8. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 485–86; *Prod. Res. Group, L.L.C.*, 863 A.2d at 790.

Bank Nederland, N.V. v. Pathe Communications Corp.[9] Its factual background and legal framework are set forth below to put the holding into perspective.

A. *Factual Background*

In 1999, Production Resources Group, L.L.C. (PRG) installed computer-controlled audio systems for NCT Group, Inc. (NCT). NCT failed to pay PRG for the equipment. Presumably because NCT represented that it could not pay the debt, and to avoid litigation, PRG agreed to enter into a "resolution agreement"[10] with NCT providing that in lieu of a full cash payment, PRG would accept from NCT $1,906,221 in cash and 6.7 million shares of NCT stock. After NCT failed to pay and failed to issue and register the stock, PRG sought and obtained a judgment in Connecticut state court against NCT in the amount of $2 million plus interest and costs. PRG thereafter tried, without success, to collect on the judgment in Connecticut.

Thereafter, Carole Salkind, the wife of one of NCT's ex-directors, supplied NCT with more than $28 million in capital in the form of equity and secured debt, even though she was a legal secretary without apparent means to account for her ability to provide the capital. As a secured creditor, Salkind obtained liens on all of the company's tangible assets, including the stock of its subsidiaries. Additionally, eight companies affiliated with the Salkind family were retained as paid consultants to the company. Although Salkind was not technically a controlling stockholder of NCT, the court noted that she had de facto control over NCT:

> *To be clear, Salkind is not technically NCT's controlling stockholder. Nonetheless, she is undisputedly the primary creditor of the company. The company has a history of defaulting on her loans, paying penalties and refinancing them, and her loans have been procured in exchange for convertible notes and warrants that, if exercised, would give her more shares of NCT than are currently outstanding. Furthermore, Salkind allegedly has liens on all the assets of NCT, including the stock of its subsidiaries. In short, it is fairly inferable that Salkind, at her will, can assume practical control over NCT by either exercising her foreclosure rights in default or by converting and becoming a controlling shareholder. In essence, PRG fairly alleges that Salkind is NCT's de facto controlling shareholder and that her interests are being inequitably favored over PRG's and other creditor's interest by a complicit board.*[11]

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9. No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

10. *Prod. Res. Group, L.L.C.*, 863 A.2d at 778. The *Production Resources* opinion denied a motion to dismiss the complaint. *Id.* at 777. As such, it accepted all well-pled facts as true. *Id.* The factual background presented herein, therefore, constitutes the facts as recited by the Court, given this legal standard.

11. *Id.* at 781.

Salkind proceeded to use this position of control to attempt to keep the company afloat and yet not pay the PRG judgment. For example, she made capital infusions into NCT's subsidiaries, rather than NCT itself, so that the cash would not be subject to the judgment. Nevertheless, Salkind took convertible notes from NCT itself as consideration for the cash advances to its subsidiaries.[12] Additionally, the company issued or pledged to Salkind and others more shares of NCT stock than was authorized by NCT's charter—indeed, billions of shares in excess of what was authorized. Additionally, in violation of Delaware law,[13] NCT did not hold a stockholder meeting for over two years, blaming its inability to afford the proxy materials associated with an annual meeting. The court also noted that, while failing to pay PRG and suffering shockingly large annual losses for five consecutive years, the company paid substantial performance-related bonuses to two of its directors.

To protect its rights, PRG filed suit in the Delaware Court of Chancery. In addition to seeking to appoint a receiver for NCT because of its insolvency,[14] PRG alleged that NCT's directors had breached their fiduciary duties owed to PRG. According to PRG, because NCT was insolvent, its directors owed fiduciary duties directly to creditors, and creditors, in their own individual capacity, could sue for breach of fiduciary duty.

B. *Legal Framework in Delaware*

The common-law[15] duties of directors and officers of a solvent corporation are well documented and understood. The primary fiduciary duties of corporate directors

12. Although not noted by the court, it appears that PRG could have argued that NCT's issuance of the convertible notes was a fraudulent transfer, either because of actual fraudulent intent or because NCT itself (as opposed to the subsidiaries) did not receive "reasonably equivalent value" in exchange for the notes. *See* DEL. CODE ANN. tit. 6, § 1304 (1999 & Supp. 2004). Interestingly, the court did note that creditors typically are protected by, inter alia, fraudulent transfer laws.

13. *See* DEL. CODE ANN. tit. 8, § 211 (2001 & Supp. 2004) (requiring stockholder meetings to be held at least every thirteen months).

14. *Prod. Res. Group, L.L.C.*, 863 A.2d at 775. PRG sought the appointment of a receiver pursuant to section 291 of the Delaware General Corporation Law, which permits the Court of Chancery, upon application by a stockholder or creditor, to appoint a receiver for a corporation which is held, after trial, to be insolvent. *Id.* The appointment of receivers under Delaware state law has become increasingly infrequent in modern times; generally, insolvent Delaware companies either voluntarily file for bankruptcy or state law dissolution or their creditors file an involuntary bankruptcy proceeding. *See* DAVID A. DREXLER ET AL., DELAWARE CORPORATE LAW & PRACTICE § 39.01, at 39–3 (2003) (concluding that section 291 is, for the most part, a "dead letter"). This aspect of the *Production Resources* opinion, however, is beyond the scope of this Article.

15. Unlike the federal and common-law jurisdictions of Canada, which will be discussed below, the source of Delaware fiduciary duty law is entirely based on common law, not a statute. *See generally* DEL. CODE ANN. tit. 8, § 141 (2001) (providing that the business and affairs of a Delaware corporation are managed by or under the direction of the board of directors, but not specifying the manner in which such directors must exercise their fiduciary duties); *see also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 937 (Del. 2003) (citation omitted) (noting that "[t]aking action that is otherwise legally possible, however, does not *ipso facto* comport with the fiduciary responsibilities of directors in all circumstances"); *id.* at 939 (stating that "Delaware corporation law . . . is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis") (Veasey, C.J., dissenting).

of a Delaware corporation are the duties of loyalty, care, and good faith.[16] The duty of care requires a director to exercise the degree of care in managing the corporation's affairs that an "ordinarily careful and prudent [person] would use in similar circumstances."[17] Before making a business decision, directors must call forth and consider "all material information reasonably available to them."[18] The duty of loyalty prohibits a corporate director from engaging in self-dealing or usurping corporate opportunities in the performance of his or her duties as a director.[19] A director's material financial interest that conflicts with or is potentially in conflict with the interests of the company directly implicates this duty. The duty of good faith requires directors to act in what they honestly believe to be the corporation's best interest as opposed to any other interest.[20]

In exercising these duties, directors of a Delaware corporation are protected by the business judgment rule. The business judgment rule is a judicially created presumption in favor of the nonconflicted (i.e., disinterested) corporate director that "in making a business decision [he/she] . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[21] The Delaware Court of Chancery has held that it is "an elementary precept of corporation law: [that] in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith."[22] This is the case even where the court believes that the board decision, in hindsight, is "substantively wrong, or . . . 'stupid' . . . 'egregious' or 'irrational.'"[23] The business judgment rule can be rebutted by a showing of a breach of the duty of care, loyalty, or good faith.[24] Once the business judgment rule is rebutted, the burden shifts to the directors to prove that the transaction was entirely fair.[25]

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16. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986); Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999).

17. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

18. Paramount Commc'ns, Inc. v. QVC Network Inc. (*In re* Paramount Commc'ns Inc. S'holder Litig.), 637 A.2d 34, 44 (Del. 1994) (citation omitted); *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

19. *See, e.g.*, Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (stating that corporate directors' fiduciary duty "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest").

20. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994) (citations omitted).

21. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted); *accord Revlon, Inc.*, 506 A.2d at 182, 184.

22. Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) (footnote omitted).

23. *In re* Caremark., 698 A.2d at 967.

24. *See, e.g.*, *Cede*, 634 A.2d at 361.

25. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116–17 (Del. 1994); *Cede*, 634 A.2d at 361.

It is well settled that the fiduciary obligations of a director of a solvent company are owed to the corporation.[26] Those same fiduciary duties extend to the corporation's shareholders who, as proprietors of the business enterprise, are the ultimate beneficiaries of the corporation's growth and increased value.[27] In contrast, directors of a solvent Delaware corporation owe no fiduciary obligation to the corporation's creditors.[28] Delaware courts have routinely rejected efforts to expand the fiduciary obligations of directors of solvent companies to creditors, finding that a creditor's rights are fixed by contract with the corporation.[29] Indeed, favoring a creditor over a shareholder of a solvent Delaware corporation might constitute a breach of the director's fiduciary obligations.[30]

When a Delaware corporation becomes insolvent in fact, the class of constituencies to whom directors owe duties expands to include creditors.[31] Although certain non-Delaware courts have held that corporate directors no longer owe a fiduciary duty to shareholders upon insolvency, the Delaware decisions are clear that upon insolvency, directors' fiduciary duties expand to include consideration of both creditors and shareholders.[32] This principle was recently reinforced by the Bankruptcy Court for the Southern District of New York, applying Delaware law, which held that Delaware law requires that "[directors] managing a corporation 'in the vicinity of insolvency,'. . . must consider the best interests of the corporation, and not just the interests of either creditors or shareholders alone."[33]

There are two primary rationales provided for the expansion of fiduciary duties to include creditors. The first, the trust fund theory, provides that the directors of an insolvent company hold the company's assets in trust for the benefit of creditors.[34] A second rationale, the "at risk" theory, contemplates that as a corporation approaches insolvency, corporate directors may adopt high-risk strategies to save

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26. *See, e.g.*, Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

27. *See, e.g.*, *Revlon, Inc.*, 506 A.2d at 179 (citations omitted); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

28. *See* Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) (stating that "[b]efore a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist"); Geyer v. Ingersoll Publ'ns. Co., 621 A.2d 784, 787 (Del. Ch. 1992).

29. *See, e.g.*, Katz v. Oak Industries, Inc., 508 A.2d 873, 879 (Del. Ch. 1986); *Simons*, 549 A.2d at 303.

30. *See Revlon, Inc.*, 506 A.2d at 182, 184.

31. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 790–91 (Del. Ch. 2004).

32. *See, e.g.*, Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1041 (Del. Ch. 1997) (finding that directors of a company "on the lip of insolvency" did not breach their fiduciary duties in preferring the interests of common equity over preferred equity, which had a liquidation preference); *Geyer*, 621 A.2d at 789; Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. Civ. A. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30 1991).

33. Official Comm. of Unsecured Creditors of RSL COM Primecall, Inc. v. Beckoff *(In re* RSL COM Primecall, Inc.), No. 01-11457, 2003 WL 22989669, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003).

34. *See, e.g.*, Am. Nat'l Bank of Austin v. MortgageAmerica Corp. *(In re* MortgageAmerica Corp.), 714 F.2d 1266, 1268–69 (5th Cir. 1983); Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944); Asmussen v. Quaker City Corp.,156 A. 180, 181 (Del. Ch. 1931).

value for shareholders unless they are tasked with additional duties to creditors.[35] In doing so, directors may put creditors, who at that point are likely the true residual claimants to and beneficiaries of the corporation, at risk if they were solely charged with maximizing value for stockholders.[36]

The *Credit Lyonnais* decision noted that sometimes "the community of interests that the corporation represents" will diverge from the best interests of stockholders even when the company is solvent, if it is in the "zone of insolvency":

> *[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.*[37]

The court posited an example, in its famous footnote fifty-five, wherein a company has but one asset—proceeds from litigation—and the expected value of the outcome of that litigation is less than the company's liabilities, but some possibility of a judgment or a settlement in excess of liabilities exists. By implying that "the right (both the efficient and the fair) course to follow"[38] arguably was to accept a settlement at or higher than the expected value—thereby ensuring insolvency and no return for the stockholders—many read this footnote to hold that creditors affirmatively have the right to enforce fiduciary duties owed to them by filing suit, as long as the company was in the zone of insolvency.[39]

C. *The Production Resources Opinion*

1. *The Court's Dicta Concerning the Zone of Insolvency and the Business Judgment Rule*

In his opinion in *Production Resources,* Vice Chancellor Leo Strine Jr. analyzed the underlying basis for the claim by PRG that NCT had breached fiduciary duties to PRG, a creditor of NCT. In doing so, in what amounts to several pages of scholarly dicta, he first took issue with the assertion that disgruntled creditors of companies that are solvent but within the zone of insolvency may affirmatively press claims of

35. *See* Donald S. Bernstein & Amit Sibal, *Current Developments: Fiduciary Duties of Directors and Corporate Governance in the Vicinity of Insolvency, in* 23RD ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND LITIGATION 653, 658 (2001).

36. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. Civ. A. 12150, 1991 WL 277613, at *n.55 (Del. Ch. Dec. 30, 1991).

37. *Id.*

38. *Id.*

39. *See, e.g.,* Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re* Buckhead Am. Corp.), 178 B.R. 956, 968–69 (D. Del. 1994) (denying a motion to dismiss because a complaint alleged that even if the company was not insolvent, it was at least in the zone of insolvency).

breach of fiduciary duties owed to them.[40] The Vice Chancellor stated that "*Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations."[41] This shield helps creditors "because directors, it can be presumed, generally take seriously the company's duty to pay its bills as a first priority."[42] The court stated that the cases that "[s]omewhat oddly . . . read . . . [*Credit Lyonnais*] as creating a new body of creditor's rights law"[43] are "not unproblematic."[44]

The court noted several fundamental problems in expanding the scope of fiduciary duties to creditors merely because the company is in the zone of insolvency. First, "[a]rguably, it involves using the law of fiduciary duty to fill gaps that do not exist."[45] The court noted that unlike stockholders, creditors can protect themselves with contractual provisions such as covenants and liens on assets.[46] Moreover, creditors are protected by fraudulent transfer laws, implied covenants of good faith and fair dealing, and to a certain extent, federal bankruptcy law.[47] The court therefore concluded,

> *[w]ith these protections, when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant. Having complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.*[48]

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40. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004).
41. *Id.*
42. *Id.*
43. *Id.* at 787–88.
44. *Id.* at 789–90.
45. *Id.*
46. *Id.* at 790.
47. *Id.* It is worth noting that the court's observations might not be accurate with respect to all creditors. For example, tort creditors cannot negotiate covenants, and many trade creditors doing small business with debtors cannot afford to and do not operate under complex contracts. Additionally, the law of fraudulent transfers protects creditors only to the extent that the business decision they are challenging was in fact a transfer; if the decision they are challenging is a *failure* to act, fraudulent transfer statutes are unhelpful. Contrast this to the statutory oppression remedy under the business corporations statutes of Canada and its common law provinces and territories, which the Supreme Court of Canada in *Peoples Department Stores* relied upon in holding that an additional remedy for breach of fiduciary duties is unnecessary. The oppression remedy appears to protect creditors in a greater percentage of circumstances than the ability to negotiate covenants and fraudulent transfer law, but Delaware does not have an oppression statute.
48. *Id.*

The court also took issue with the concept that the constituency to whom fiduciary duties are owed fundamentally changes when a company is solvent but in the zone of insolvency, on two different grounds.[49] First, it noted that the zone "is an admittedly confusing one" to define, and is "not . . . a simple exercise," permitting "talented creditors' lawyers [to] . . . press for an expansive view."[50] Coupled with the lenient pleading standards, a legal principle permitting creditors to pursue claims against directors if the "company is within some imprecise and hard-to-define vicinity of insolvency" will lead to a proliferation of suits against directors of companies later determined to be solvent but which survive a motion to dismiss.[51] Second, presumably stockholders would not lose the right to sue directors of a corporation in the zone of insolvency, which means that directors could be exposed to competing suits arguing for mutually exclusive, indeed polar opposite, outcomes.[52] In this regard, the court noted that although creditors of insolvent corporations are often referred to as the company's residual risk bearers, that is not entirely accurate—just that a company is insolvent does not mean it cannot, under any circumstances, turn around and leave some benefit for equity. Creditors have no incentive to push the company to take a course of action leading to that result; all they care about is getting paid as close to full recovery as possible.[53]

Given this tension, the court took pains to emphasize that faced with competing creditor and stockholder goals, the duties of directors run primarily "to the firm and their duty to responsibly maximize its value, a duty that might require pursuing a strategy that neither the stockholders nor the creditors would prefer."[54] It often is an admittedly difficult task to balance these competing constituencies and determine what, in fact, is in the best interests of the corporate enterprise. Thus, the Vice Chancellor stated that he "doubt[s] the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone."[55] In a reaffirma-

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49. Interestingly, despite citing *Production Resources* with approval on other points, a federal court in Delaware recently held that in order to maintain suit against officers and directors for breach of fiduciary duty, a liquidation trust comprised of creditors had the "burden to prove that the Director Defendants owed a duty to the creditors by proving that Hechinger was operating *in the vicinity of insolvency*." Liquidation Trust of Hechinger Inv. Co. v. Fleet Retail Fin. Group (*In re* Hechinger Inv. Co.), 327 B.R. 537, 548 (D. Del. 2005) (emphasis added). Given that the discussion of the zone of insolvency in *Production Resources* was dicta (albeit scholarly dicta), and the many cases that preceded it that referred favorably to the commencement of duties to creditors upon the company's falling into the zone of insolvency, it is likely that the concept will continue to pervade despite *Production Resources* until a more definitive ruling decides the issue.

50. *Prod. Res. Group, L.L.C.*, 863 A.2d at 789 n.56; *see also id.* at 788 n.52 (commenting that "I doubt . . . that there is a magic dividing line that should signal the end to some, most, or all risk-taking on behalf of . . . creditors").

51. *Id.* at 789 n.56.

52. *Id.*

53. *Id.* at 790 n.57.

54. *Id.* (citing Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. Civ. A. 12150, 1191 WL 277613, at *34 n.35 (Del. Ch. Dec. 30, 1991); *see also* Geyer v. Ingersoll Publ'ns. Co., 621 A.2d 784, 789 (Del. Ch. 1992) (stating that directors should "choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation").

55. *Prod. Res. Group, L.L.C.*, 863 A.2d at 790 n.57.

tion of the business judgment rule in the context of creditor-initiated suits,[56] the court asked, "Absent self-dealing or other evidence of bad faith, by what measure is a court fairly to critique the choice [of creditor versus shareholder interests] made through an award of damages?"[57]

In a recently published law review article, the former Chief Justice of the Delaware Supreme Court agreed that *Production Resources* "reaffirms what, in [his] view, has always been the law—that directors who make good faith, careful judgments in the honest belief that they are acting in the best interests of the corporation should not fear liability."[58]

2. *The Holding: Fiduciary Duties are Owed to Creditors if the Company is Insolvent, but Creditors Only have Derivative Standing to Sue*

Although the court's exploration of the zone of insolvency described above will likely have long-ranging consequences and be cited in cases and articles around the United States, it is all dicta; the court itself noted that "[f]ortunately, this case does not require me to explore the metaphysical boundaries of the zone of insolvency."[59] Instead, the court held that at least at the pleadings stage, PRG successfully alleged that NCT was insolvent in fact. Therefore, the court applied the "more well-settled line of authority": "When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors."[60]

Unlike allowing creditors to sue a company that merely is in the zone of insolvency, the court held that this "uncontroversial proposition . . . does not completely turn on its head the equitable obligations of the directors *to the firm itself*."[61] After all, both before and after insolvency, the directors' focus is to maximize the company's value, either as a going concern or, if appropriate, in a sale—"[t]hat much of their job does not change."[62] Rather, insolvency merely "affect[s] the constituency on whose behalf the directors are pursuing that end."[63] For example, "poor deci-

56. *See* Angelo, Gordon & Co., L.P. v. Allied Riser Comm. Corp., 805 A.2d 221, 229 (Del. Ch. 2002) (finding that "there is room for application of the business judgment rule" in suits commenced by creditors); Liquidation Trust of Hechinger Inv. Co. v. Fleet Retail Fin. Group (*In re* Hechinger Inv. Co.), 327 B.R. 537, 549 (D. Del. 2005) (citing *Production Resources* for the proposition that "the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms").

57. *Prod. Res. Group, L.L.C.*, 863 A.2d at 790 n.57; *see also id.* at 788 n.52 (noting that "the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms").

58. E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992–2004?: A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1430 (2005).

59. *Prod. Res. Group, L.L.C.*, 863 A.2d at 790.

60. *Id.* at 790–91.

61. *Id.* at 791(emphasis added).

62. *Id.*

63. *Id.*

sions by management may erode the value of the remaining assets, leaving the corporation with even less capital to satisfy its debts in an ultimate dissolution."[64] As a result, "[t]he elimination of the stockholders' interest in the firm and the increased risk to creditors is said to justify imposing fiduciary obligations towards the company's creditors on the directors."[65]

The fact that fiduciary duties are owed to creditors, however, transforms neither the relationship between any particular creditor and the company, nor the nature of the harm if directors fail to carry out their duties. The creditor-company relationship is still governed by contract and other law. Moreover, the court reaffirmed its holding from a 1931 opinion that "the mere fact that directors of an insolvent firm favor certain creditors over others of similar priority does not constitute a breach of fiduciary duty, absent self-dealing."[66]

Moreover, and perhaps more central to the court's actual holding, the nature of the harm for breach of fiduciary duties owed to creditors is a harm to the corporation, not to any creditor individually.[67] Thus, a suit for breach of fiduciary duties owed to creditors is a classically derivative suit. According to the court, "[t]he reason for this bears repeating—the fact of insolvency does not change the primary object of the director's duties, *which is the firm itself*."[68] Thus, although "the firm's directors *are said* to owe fiduciary duties to the company's creditors"[69] and "the increased risk to creditors *is said* to justify imposing fiduciary obligations towards the company's creditors,"[70] those duties (as well as duties owed to stockholders) are ultimately subservient to the duties owed to the corporation itself.[71]

64. *Id.*

65. *Id.*

66. *Id.* at 791–92 (citing Asmussen v. Quaker City Corp., 156 A. 180, 181 (Del. Ch. 1931)). Of course, if such a course of action were pursued today, creditors would have a potential remedy: they could cause such payments to be avoided by filing an involuntary bankruptcy case and a fraudulent conveyance and/or preference lawsuit.

67. *Id.* at 792 (stating that "even in the case of an insolvent firm, poor decisions by directors that lead to a loss of corporate assets and are alleged to be a breaches [sic] of equitable fiduciary duties remain harms to the corporate entity itself").

68. *Id.* (emphasis added).

69. *Id.* at 790–91 (emphasis added).

70. *Id.* at 791 (emphasis added).

71. One might reasonably ask whether the Vice Chancellor's language, which is uncharacteristically stated in the passive voice ("are said to owe"; "is said to justify"; "does not completely turn on its head"), implies that he believes that denominating these as fiduciary duties to creditors is either not technically accurate, confusing, or not really justified, but has become settled in previous Delaware cases. After all, the court's comment that creditors are protected by covenants, fraudulent transfer laws and federal bankruptcy law appears equally applicable to insolvent companies as to companies in the zone of insolvency. *See id.* at 790. Moreover, the Vice Chancellor states that the rationale for imposing fiduciary duties to creditors on directors of insolvent companies in part rests on "the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers," *id.* at 791, a theory he shied away from earlier in the same opinion. *See id.* at 790 n.57 (noting that "[o]f course, when a firm is insolvent, creditors do not become residual claimants with interests entirely identical to stockholders, they simply become the class of constituents with the key claim to the firm's remaining assets"). In any event, because the primary duty is to the company itself, and creditors cannot directly sue for breaches of duties owed to them, the phrasing is likely academic.

The derivative nature of these types of claims has two primary effects. First, before bankruptcy, a creditor who wants to commence such a suit must meet all of the typical requirements of derivative suits. For example, demand must be either refused or excused, and presumably there could be representative plaintiff issues and continuous ownership (in this case, indebtedness) requirements.[72] The Court of Chancery's holding, however, stating that these types of suits are derivative, should have much less of an influence on the litigation of such suits once a bankruptcy case has been filed.[73] In a bankruptcy case, a trustee or a debtor in possession (or a post-confirmation liquidation trust) unquestionably has direct standing to bring causes of action for breach of fiduciary duties. Further, the creditors' committee can also move to obtain standing to pursue derivative claims.[74] In either case, the issue outside of bankruptcy—certain disgruntled creditors attempting to challenge the ongoing conduct of a board of directors that remains in control of the company and to receive damages resulting from that conduct—is rarely encountered in bankruptcy adversary proceedings.

The second primary effect of the holding that these claims are derivative is that directors can be exculpated from liability under certain circumstances—the subject described immediately below.

3. *Exculpation of Directors From Personal Liability*

Although the Court of Chancery in *Production Resources* denied a motion to dismiss most counts of the complaint, it granted, pursuant to section 102(b)(7) of the Delaware General Corporation Law, the motion to dismiss the count which sought damages for breach of the duty of care. Pursuant to section 102(b)(7), a corporation may include in its certificate of incorporation a provision that exculpates its directors from personal liability "to the corporation or its stockholders" for monetary damages for breach of the fiduciary duty of care.[75] The statute makes no express mention of whether such an exculpation clause in a certificate of incorporation also shields directors from personal liability if the suit for personal liability is filed by a creditor.

Before the *Production Resources* decision, three non-Delaware federal courts had addressed the issue, and two held that a section 102(b)(7) exculpation clause does not shield directors from personal liability for suits filed by the corporation's creditors for breach of the duty of care or waste of the corporation's assets.[76] Those

72. *See* DEL. CODE ANN. tit. 8, § 327 (2004); DEL. CH. CT. R. 23.1.

73. Russell C. Silberglied & Kimberly D. Newmarch, *Production Resources Decision: A Retreat from the Law on Fiduciary Duties to Creditors of Insolvent Companies or Merely an Explanation of Standing Requirements?*, THE BANKR. STRATEGIST (Law Journal Newsletter, Philadelphia, Pa.), March 2005, at 6.

74. *See, e.g.*, Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 566 (3d Cir. 2003).

75. DEL. CODE ANN. tit. 8, § 102(b)(7) (2004).

76. *See* Pereira v. Cogan, No. 00 CIV. 619 (RWS), 2001 WL 243537, at *9 (S.D.N.Y. Mar. 8, 2001); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), No. 97C7934, 97C6043, 2000 WL 28266, at *7–*8 (N.D.

courts reasoned that the statute did not specifically mention creditors and therefore did not cover suits filed by creditors.[77] Additionally, they held that a certificate of incorporation is a contract between a corporation and its stockholders, and not a contract between the corporation and its creditors.[78] Thus, according to those courts, because creditors never contractually agreed to such a provision, the section 102(b)(7) exculpation clause is not enforceable against such creditors.

In *Production Resources*, the Court of Chancery held that a section 102(b)(7) exculpation clause does protect directors from suits brought by creditors.[79] The holding was guided by the court's decision that suits by creditors for breach of fiduciary duties by directors are derivative in nature. Thus, even when a creditor derivatively prosecutes such a suit, it is the corporation's claim. Therefore, it fits within the literal wording of section 102(b)(7): "to *the corporation* or its stockholders."[80]

In addition to fitting within the literal wording of the section 102(b)(7), the Court of Chancery also held that the legislative policy behind section 102(b)(7) would be frustrated if the Court of Chancery were to follow the *Pereira* and *Steinberg* decisions. It has long been noted that the policy behind the enactment of section 102(b)(7) was to encourage talented individuals to serve as directors of Delaware corporations, free from fear that they would be held personally liable if their good faith decisions later turned out to have been poor ones.[81] Thus, if the Court of Chancery were to hold that directors might have to pay out-of-pocket damages to creditors who challenged their good-faith, disinterested decision making, a section 102(b)(7) exculpation clause would be essentially gutted and ineffective at the time it is most needed. After all, the court reasoned, suits are most likely to be filed when there is a reason to second guess the directors because the company's fortunes turned out poorly, and therefore that is when directors need the protections of section 102(b)(7) the most.

Production Resources has already been followed by the United States District Court for the District of Delaware (the "District Court"). In *Star Telecommunications*, the District Court held that *Production Resources* is the law of Delaware that should be followed when deciding issues involving section 102(b)(7) of the Delaware General Corporation Law.[82] Additionally, although neither section 102(b)(7) nor the corporation's charter was mentioned in the complaint filed by the official

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Ill. Jan. 12, 2000), *but see* Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997); Pereira v. Farace, 413 F.3d 330, 341–42 (2d Cir. 2005).

77. *See Pereira*, 413 F.3d at 342; *Steinberg*, 2001 WL 28266, at *8.

78. *See Pereira*, 413 F.3d at 342; *Steinberg*, 2001 WL 28266, at *8.

79. 863 A.2d 772, 793–95 (Del. Ch. 2004).

80. DEL. CODE ANN. tit. 8, § 102(b)(7) (2004) (emphasis added).

81. E. Norman Veasey, Jesse A. Finkelstein, & C. Stephen Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 403–04 (1987).

82. Continuing Creditors' Comm. of Star Telecomm. Inc. v. Edgecomb, 385 F. Supp. 2d 449, 462–63 (D. Del. 2004).

committee of unsecured creditors, the District Court invoked section 102(b)(7) as a defense on a motion to dismiss the case pursuant to Federal Rule of Civil Procedure 12(b)(6).[83] This holding is for the most part consistent with the Delaware Supreme Court's holding that a case can be dismissed at the pleadings stage by invoking a section 102(b)(7) clause, albeit introducing this outside document converts the motion to dismiss to one for summary judgment; despite the conversion, a plaintiff cannot take discovery on the 102(b)(7) clause unless it has a good faith basis to challenge its authenticity or the propriety of its adoption.[84]

Thus, *Star Telecommunications* makes it clear that if a Delaware corporation's certificate of incorporation contains a section 102(b)(7) exculpation clause, the holding of *Production Resources* is applicable in suits brought in bankruptcy court. Accordingly, directors are shielded from personal liability for monetary damages for breach of their duty of care regardless of whether such suits are initiated by the corporation, stockholders, creditors or an official committee of unsecured creditors. On June 30, 2005, the Second Circuit Court of Appeals agreed, reversing *Pereira* and citing *Production Resources* with approval.[85] In so holding, the Second Circuit confirmed that (a) suits brought by bankruptcy trustees also are governed by section 102(b)(7), and (b) that courts outside of Delaware will look to *Production Resources* as the authority to apply when confronted with these issues.

II. *PEOPLES V. WISE*: THE SUPREME COURT OF CANADA ADDRESSES DIRECTOR DUTIES TO CREDITORS

The principal question raised before the Supreme Court of Canada in *Peoples Department Stores* was whether directors of a corporation owe a fiduciary duty to the corporation's creditors comparable to the statutory duty owed to the corporation.[86] Although the court put the question before it in such simple terms and decided that no such fiduciary duty exists, it took the opportunity, as did the Delaware Court, to explore in dicta the duties and responsibilities of directors of both solvent and insolvent corporations.

The decision of the Supreme Court of Canada was released in late October 2004. Although the Court did not have the benefit of the decision in *Production Resources,* it considered the U.S. approach to the "best interests of the corporation," "the trust doctrine," and the "business judgment rule."[87] It cited with favor an article coauthored by Vice Chancellor Leo Strine, Jr., "Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law," who was about to

83. *Id.*
84. Malpiede v. Townson, 780 A.2d 1075, 1091–92 (Del. 2001).
85. Pereira v. Farace, 413 F.3d. 330 (2d Cir. 2005).
86. [2004] 3 S.C.R. 461, 466.
87. *Id.* at 492.

release his opinion in *Production Resources*.[88] Like the Delaware Court, the Supreme Court of Canada stated that the primary duty of the directors is to act in the best interests of the corporation.[89]

A. *Factual Background*

Wise Stores Inc. ("Wise") was founded by Alex Wise in 1930 as a small clothing store in Montreal, Quebec. By 1992, through internal growth and acquisitions, it had become a publicly traded company operating fifty locations with annual sales of approximately $100 million. The stores were mostly located in urban areas of Quebec. The founder's three sons, Lionel, Ralph, and Harold Wise (the "Wise brothers"), were simultaneously majority shareholders, officers, and directors of the corporation. Together, they controlled seventy-five percent of the firm's equity.

In 1992, Peoples Department Stores Inc. ("Peoples") had been in business continuously in one form or another for seventy-eight years. It operated as an unincorporated division of Marks & Spencer Canada Inc. ("M&S") until 1991, when it was incorporated as a separate company. M&S itself was wholly owned by Marks and Spencer plc ("M&S plc"), a large British firm. Peoples' eighty-one stores were predominantly located in rural areas, from Ontario to Newfoundland. Peoples had annual sales of approximately $160 million, but the company still struggled financially. Its annual losses approached $10 million.

By late 1991, M&S plc had decided to divest itself of all its Canadian operations. Wise had been interested in purchasing M&S for several years, and a deal was reached.

Wise incorporated a new company, 2798832 Canada Inc., for the purpose of acquiring all of the issued and outstanding Peoples shares from M&S. The parties entered into a share purchase agreement, with a purchase price of $27 million.

The $5 million down payment due to M&S at closing was borrowed from the Toronto Dominion Bank (the "TD Bank"). According to the terms of the share purchase agreement, the $22 million balance of the purchase price would be repaid by M&S over eight years. Wise guaranteed all of the obligations of 2798832 Canada Inc. pursuant to the terms of the share purchase agreement.

To protect its interests, M&S took a security interest over the assets of Peoples (subject to a priority in favor of the TD Bank) and negotiated strict covenants concerning the financial management and operation of the company. In particular, Peoples could not be amalgamated with Wise until the purchase price had been paid. This prohibition, in addition to others, was presumably intended to induce

88. William T. Allen, Jack B. Jacobs, & Leo E. Strine Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859 (2001). Vice Chancellor Strine's coauthors in this article are former Chancellor Allen, who authored the *Credit Lyonnais* decision, and Justice Jacobs of the Delaware Supreme Court.

89. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 480.

Wise to refinance and pay the remainder of the purchase price as early as possible in order to overcome the strict conditions imposed upon it under the share purchase agreement.

On January 31, 1993, 2798832 Canada Inc. was amalgamated with Peoples. The new entity retained Peoples' corporate name. Because 2798832 Canada Inc. had been a wholly owned subsidiary of Wise, upon amalgamation, the new Peoples became a subsidiary directly owned and controlled by Wise. The Wise brothers were Peoples' only directors.

After the acquisition, Wise attempted to rationalize its operations by consolidating the overlapping corporate functions of Wise and Peoples. The joint operation of Wise and Peoples did not function smoothly. Parallel bookkeeping combined with shared warehousing arrangements caused serious problems for both Wise and Peoples. Both the Wise and Peoples stores experienced numerous shipping disruptions and delays, and inventory records were incorrect and unreliable.

To address the problems, the Wise brothers agreed that they would implement a joint inventory procurement policy (the "new policy") whereby the two companies would divide purchasing responsibility. 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 from North American suppliers, charging Wise accordingly. Similarly, Wise would transfer to Peoples what it had purchased for Peoples from overseas suppliers, charging Peoples accordingly. About eighty-two percent of the total inventory of Wise and Peoples was purchased from North American suppliers, which inevitably meant that Peoples would be extending a significant trade credit to Wise.

The new policy, which was implemented February 1, 1994, was the cause of the claims against the Wise brothers after the businesses collapsed. By June 1994, financial statements prepared to reflect the financial position of Peoples as of April 30, 1994, revealed that Wise owed more than $18 million to Peoples. M&S was concerned about the situation and insisted that the new policy be rescinded. An agreement was executed on September 27, 1994, effective July 21, 1994, which provided that the new policy would be abandoned as of January 31, 1995. The agreement also specified that the inventory and records of the two companies would be kept separate, and that the amount Wise owed to Peoples would not exceed $3 million.

In September 1994, in light of the fragile financial condition of the companies and the competitiveness of the retail market, the TD Bank announced its intention to cease doing business with Wise and Peoples as of the end of December 1994. After negotiations, however, the bank extended its financial support until the end of July 1995.

In December 1994, the Wise brothers presented financial statements showing disappointing results for Peoples in its third fiscal quarter. Three days later, M&S initiated bankruptcy proceedings against both Wise and Peoples. A notice of intention to make a proposal was filed on behalf of Peoples the same day. Nonetheless,

Peoples later consented to the petition by M&S, and both Wise and Peoples were declared bankrupt on January 13, 1995, effective December 9, 1994.

The assets of Wise and Peoples were sufficient to cover in full the outstanding debt owed to the TD Bank, satisfy the entire balance of the purchase price owed to M&S, and discharge almost all the landlords' lease claims. The bulk of the unsatisfied claims were those of unsecured trade creditors.

After the bankruptcy, Peoples' trustee in bankruptcy filed a petition against the Wise brothers. The trustee claimed that the Wise brothers had favored the interests of Wise over Peoples to the detriment of Peoples' creditors, in breach of their duties as directors under section 122(1) of the Canada Business Corporations Act ("CBCA").[90]

The Quebec Superior Court found the Wise brothers liable under the CBCA and held that directors' duties under section 122 of the CBCA, which require them to take reasonable care and to act in good faith with a view to the best interests of the corporation, are owed to creditors in the vicinity of insolvency.[91] The Quebec Superior Court found that the Wise brothers breached that duty.[92] On appeal, the Quebec Court of Appeal was not persuaded by considerable precedent from other jurisdictions suggesting that such duty shifted to creditors of insolvent or "near insolvent" businesses.[93] The trustee obtained leave to appeal to the Supreme Court of Canada.[94]

These decisions set off an intense academic debate as to the scope of director duties in Canada and the extent to which they do or do not, or should or should not, shift to different stakeholders when a company is insolvent or in the vicinity of insolvency. The matter has now been settled by the Supreme Court of Canada, with obiter remarkably similar to that of the Delaware Court.

B. *Legal Framework In Canada*

The case came before the Supreme Court of Canada on the issue of whether directors owe a duty to creditors under the CBCA. As described above, the duties of directors of Delaware corporations are established by common law. Duties of directors of corporations incorporated federally under the CBCA or under the business corporations statutes of the common-law provinces and territories of Canada are set out in the respective business corporations statutes. "That directors must satisfy

90. Canada Business Corporations Act, R.S.C. 1985, c. C-44 § 122(1) (1985) [hereinafter CBCA].

91. [1998] 23 C.B.R. (4th) 200, [1998] Q.J. No. 3571, [1998] CarswellQue 3442 (Que. S.C.), *rev'd* [2003] 41 C.B.R. (4th) 225 (Que. C.A.), *leave to appeal allowed* [2003], 321 N.R. 193 (note) (S.C.C.), *aff'd* [2004] 3 S.C.R. 461 (S.C.C.).

92. *Id.*

93. [2003] 224 D.L.R. (4th) 509, 531–32 (Que. C.A.).

94. For a comprehensive analysis of the decisions of the Quebec Superior Court and the Quebec Court of Appeal, see Janis. P. Sarra, "Wise People, Fiduciary Obligation and Reviewable Transactions: Directors' Liability to Creditors," in *Annual Review of Insolvency Law* (Janis P. Sarra ed., Thomson Carswell 2003). *See also* Edward M. Iacobucci, *Directors' Duties in Insolvency: Clarifying what is at Stake*, 39 CAN. BUS. L.J. 398 (2003).

a duty of care is a long-standing principle of the common law [in Canada], although the duty of care has been reinforced by statute to become more demanding."[95] The appeal before the Supreme Court of Canada focused on the statutory rather than the common-law duties of directors.[96]

Subsection 122(1) of the CBCA establishes two distinct duties to be discharged by directors and officers in managing, or supervising the management of, the corporation:

> *122. (1) Every director and officer of a corporation in exercising their powers and discharging their duties shall*
> *(a) act honestly and in good faith with a view to the best interests of the corporation; and*
> *(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.*[97]

The Supreme Court of Canada reviewed these duties and their availability to creditors in the context of Canadian corporate law.[98] As the common law requires in Delaware,[99] directors in Canada by both statute and common law must act honestly and in good faith, with due care, diligence, and skill.[100]

> *They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. . . . Directors and officers must serve the corporation selflessly, honestly, and loyally.*[101]

If they fail to do so, they may be held accountable by the corporation itself or by its trustee in bankruptcy, or through a derivative action by shareholders or creditors. Any deference to business judgment is to be accorded only when directors have made a decision and exercised their judgment in an informed and independent fashion, after a reasonable analysis of the situation and acting on a rational basis with reasonable grounds.[102]

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95. Peoples Dep't Stores Inc. (Trustee of) v. Wise (*In re* Peoples Dep't Stores Inc.), [2004] 3 S.C.R. 461, 489.

96. *Id.* at 481.

97. CBCA § 122(1). For similar provisions in provincial legislation, see, for example, Alberta Business Corporations Act, R.S.A. 2000, ch. B-9 § 122; Manitoba Corporations Act, R.S.M. 1987, ch. C 225 § 114(2), (3); Ontario Business Corporations Act, R.S.O. 1990, ch. B 16 § 134.

98. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 476–93.

99. *See* discussion *supra* Part I.B.

100. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 477–80.

101. *Id.* at 477.

102. *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, [2002] 214 D.L.R. (4th) 496, 530 (Ont. S.C.J.), *aff'd* [2004] (sub nom. *UPM-Kymmene Corp. v. Repap Enterprises Inc.*) 183 O.A.C. 310 (Ont. C.A.).

One of the distinctive features of Canadian corporate law is the availability of the oppression remedy,[103] in addition to derivative claims for breach of director duties, which are also available in the United States. The oppression remedy changes considerably the landscape for director duties in Canada, as compared to the United States.

Section 241(2) of the CBCA (and similar provisions of business corporation statutes in the common-law provinces)[104] allows a complainant to apply to the court for an order if:

> *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.*[105]

A *complainant* is defined as a security holder or former security holder, a director and officer or a former director and officer, the Director appointed by the government to administer the statute, or "any other person who, in the discretion of a court, is a proper person to make an application."[106]

The Court has extremely broad powers under section 241(3) of the CBCA to make such orders it thinks fit if it concludes that oppressive conduct has occurred. For instance, the court may make interim or final orders: (i) restraining the conduct complained of; (ii) appointing a receiver or receiver-manager; (iii) liquidating and dissolving the corporation; and (iv) compensating an aggrieved person.[107]

Much of the litigation under the oppression remedy concerns disputes between majority and minority shareholders in closely held corporations. It has also been used, however, to grant relief to creditors as well as shareholders, including orders compensating aggrieved creditors for the oppressive conduct of directors. "The fact that creditors' interests increase in relevancy as a corporation's finances deteriorate

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103. *See* CBCA § 241(2).

104. For similar provisions in provincial legislation, see for example, Alberta Business Corporations Act § 242, British Columbia Business Corporations Act, S.B.C. 2002, ch. 57, § 227, and Ontario Business Corporations Act § 248.

105. CBCA § 241(2).

106. *Id.* § 238; *see also* Alberta Business Corporations Act § 239 (stating that the definition of *complainant* includes "a creditor," provided that leave is granted by the court); Ontario Business Corporations Act § 245.

107. CBCA §241(3).

is apt to be relevant to, *inter alia*, the exercise of discretion by a court in granting standing to a party as a 'complainant' [invoking the oppression remedy.]"[108]

The Supreme Court of Canada noted in *Peoples Department Stores* the particular Canadian corporate law landscape:

> *The Canadian legal landscape with respect to stakeholders is unique. Creditors are only one set of stakeholders, but their interests are protected in a number of ways. Some are specific, as in the case of amalgamation: s. 185 of the CBCA. Others cover a broad range of situations. The oppression remedy of s. 241(2)(c) of the CBCA and the similar provisions of provincial legislation regarding corporations grant the broadest rights to creditors of any common law jurisdiction: see D. Thomson, "Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?" (2000), 58 U.T. Fac. L. Rev. 31, at p. 48. One commentator describes the oppression remedy as "the broadest, most comprehensive and most open-ended shareholder remedy in the common law world": S.M. Beck, "Minority Shareholders' Rights in the 1980s", in Corporate Law in the 80s (1982), 311, at p. 312. While Beck was concerned with shareholder remedies, his observation applies equally to those of creditors.*
>
> *The fact that creditors' interests increase in relevancy as a 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" under s. 238(*d*) of the CBCA as a "proper person" to bring a derivative action in the name of the corporation under ss. 239 and 240 of the CBCA, or to bring an oppression remedy claim under s. 241 of the CBCA.*[109]

The two instruments, statutory director duties and the oppression remedy, are aimed at different kinds of conduct, although the facts in a particular case may give rise to breaches of both.[110] Within this corporate landscape, the court considered the statutory duties of directors under section 241 of the CBCA.

C. *The Decision in* Peoples Department Stores

The court considered sections 122(1)(a) and 122(1)(b) of the CBCA as creating two distinct duties, designed to secure different ends, which had to be addressed separately.[111] The first duty was referred to in the *Peoples Department Stores* case as the "fiduciary duty," the duty under section 122(a) to act honestly and in good

108. Peoples Dep't Stores Inc. (Trustee of) v. Wise (*In re* Peoples Dep't Stores Inc.), [2004] 3 S.C.R. 461, 484–85.

109. *Id.*

110. For a comprehensive discussion, see E. Iacobucci & K. Davis, *Reconciling Derivative Claims and the Oppression Remedy*, (2000) 12 S.C.L.R. (2d) 87.

111. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 476.

faith with a view to the best interests of the corporation.[112] The court held that it is better described as the "duty of loyalty," incorporating American terminology.[113] Throughout its decision, however, the court used the expression "statutory fiduciary duty" for purposes of clarity when referring to this duty under the CBCA.[114]

The second duty was referred to in the *Peoples* case as the "duty of care," the duty under section 122(1)(b) to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[115] "Generally speaking, [this duty of care] imposes a legal obligation upon directors and officers to be diligent in supervising and managing the corporation's affairs."[116]

The following is a summary of the consideration by the Supreme Court of Canada of these two duties.

1. *The Statutory Fiduciary Duty: Section 122(1)(a) of the CBCA*

"The statutory fiduciary duty requires directors and officers to act honestly and in good faith [in respect of] the corporation."[117] The Supreme Court of Canada described such duty of the directors as one to maximize the value of the corporation:

> *Insofar as the statutory fiduciary duty is concerned, 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. . . .*[118]

The court stated 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.*[119]

At all times, however, "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," although those interests fall

112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.* at 477.
118. *Id.* at 481.
119. *Id.* at 482.

within the consideration of the directors in seeking to maximize the value of the corporation.[120]

Unlike the Delaware court, the Supreme Court of Canada stated that the statutory fiduciary duty does not extend to creditors.[121] Like the Delaware court, and using similar language, however, it dismissed the concept of any shifting duties when a corporation is in the vicinity of insolvency.[122] It recognized that there will be various shifts in interest that naturally occur as a corporation's fortunes rise and fall, without altering the fiduciary duty of the directors:

> *The directors' fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency". That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability. In assessing the actions of directors it is evident that any honest and good faith attempt to redress the corporation's financial problems will, if successful, both retain value for shareholders and improve the position of creditors. If unsuccessful, it will not qualify as a breach of the statutory fiduciary duty.*[123]

In *Production Resources*, Vice Chancellor Strine described the zone of insolvency as "an admittedly confusing one" to define and "not . . . a simple exercise."[124] The Supreme Court of Canada took this concept to its logical conclusion and declared the zone of insolvency to be "incapable of definition" and as having "no legal meaning."[125]

Vice Chancellor Strine held that the fiduciary duty of directors should not be used to fill gaps that do not exist.[126] The Supreme Court of Canada found no gap to fill as well:

> *In light of the availability both of the oppression remedy and of an action based on the duty of care, which will be discussed below, stakeholders have viable remedies at their disposal. There is no need to read the interests of creditors into the duty set out in s. 122(1)(*a*) of the CBCA. Moreover, in the circumstances of this case, the Wise brothers did not breach the statutory fiduciary duty owed to the corporation.*[127]

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120. *Id.* at 482–83.
121. *Id.* at 481–83, 486.
122. *Id.* at 483.
123. *Id.*
124. *See* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 789 n.56 (Del. Ch. 2004).
125. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 483.
126. *Prod. Res. Group, L.L.C.*, 863 A.2d at 789–91.
127. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 486.

The court found that the Wise brothers did not breach their statutory fiduciary duty.[128] In seeking to maximize the value of the corporation, the court described the statutory fiduciary duty of directors as the pursuit of "a better corporation."[129] The court noted that, in *820099 Ontario Inc. v. Harold E. Ballard Ltd.*,[130] Mr. Justice Farley held that in resolving a conflict between majority and minority shareholders, it is safe for directors to act to make the corporation "a better corporation."[131] The Supreme Court of Canada adopted that same expression and found that the Wise brothers did not breach their statutory fiduciary duty in seeking to make both Wise and Peoples "better corporation[s]."[132]

2. The Statutory Duty of Care: Section 122(1)(b) of the CBCA

Unlike the fiduciary duty in section 122(1)(a) of the CBCA, which specifies that directors and officers must act with a view to the best interests of the corporation, the court commented that "the duty of care in s. 122(1)(b) of the CBCA does not specifically refer to an identifiable party as the beneficiary of the duty."[133] Importantly, the court stated that "the identity of the beneficiary of the duty of care is much more open-ended, and it appears obvious that it must include creditors."[134]

The statutory duty of care under section 122(1)(b) is characterized "as an objective standard," what a reasonably prudent person would do in comparable circumstances, and the factual aspects of the circumstances surrounding the actions of the director or officer are important.[135]

As in Delaware, deference is given to the directors under the business judgment rule. The court held as follows:

> *The contextual approach dictated by s. 122(1)(b) of the CBCA not only emphasizes the primary facts but also permits prevailing socio-economic conditions to be taken into consideration. . . . Canadian courts, like their counterparts in the United States, the United Kingdom, Australia and New Zealand, have tended to take an approach with respect to the enforcement of the duty of care that respects the fact that directors and officers often have business expertise that courts do not. Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. Business decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which de-*

128. *Id.*
129. *Id.* at 484.
130. 820099 Ontario Inc. v. Harold E. Ballard Ltd. (1991), 3 B.L.R. (2d) 123, *aff'd* (1991), 3 B.L.R. (2d) 113.
131. *In re Peoples Dep't Stores Inc.*, [2004] 3 S.C.R. at 486.
132. *Id.* at 481.
133. *Id.* at 488.
134. *Id.*
135. *Id.* at 491.

tailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available ex post facto. *Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the "business judgment rule", adopting the American name for the rule.*[136]

Directors and officers will not be held in breach of the duty of care under section 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis:

The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. 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 facts of any case, of determining whether an 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.[137]

The court was clear: "[P]erfection is not demanded."[138] Rather, the decisions made by the directors must be reasonable business decisions in light of all the circumstances about which the directors knew or ought to have known.[139]

The Court found that the Wise brothers, in exercising their business judgment, met the requisite standard of "a reasonable business decision" based on the business judgment rule and did not breach the duty of care.[140]

D. *Opening or Closing the Gap on Creditor Claims Against Directors?*

The Supreme Court of Canada clarified the fiduciary duties of directors of Canadian corporations, as did the Delaware Court of Chancery in its jurisdiction. Directors of corporations do not owe a separate fiduciary duty to creditors of a corporation in an insolvency situation. In Delaware, there is a fiduciary duty to creditors, but duties do not shift to creditors in an insolvency scenario. Instead, they expand to include shareholders and creditors. The nature of the duties does not change. In Canada, there is no such statutory fiduciary duty owed to the creditors, whether the corporation is solvent or not. The duty remains to the corporation and does not shift in an insolvency.

136. *Id.* at 491–92.
137. *Id.* at 493.
138. *Id.*
139. *Id.*
140. *Id.*

In considering the section 122(b) "duty of care," the Supreme Court of Canada stated that such duty extends to creditors.[141] To what extent does such statement in *obiter dicta* open the floodgates for claims by creditors against directors? The Court acknowledged that the civil law serves as a supplementary source of law to federal legislation such as the CBCA.[142] Otherwise, the Court states that "the CBCA does not entitle creditors to sue directors directly for breach of their duties."[143] The Court relied on specific provisions of the Quebec Civil Code that gave creditors a right to bring an action for alleged breaches of statutory duties of care in Quebec.[144] Article 1457 of the Quebec Civil Code requires a person to abide by rules of conduct imposed on him by "circumstances, usage or law, so as not to cause injury to another."[145]

There are no similar statutory provisions in the common-law provinces and territories of Canada. The Supreme Court of Canada did not indicate in its reasons to what extent the section 122(b) duty of care, although it extends to creditors, could be actionable by creditors in common-law jurisdictions. Directors may be sued for breach of such duty by the corporation (or the trustee in bankruptcy of the corporation for the benefit of the creditors). The cause of action of the corporation against the directors could be taken up derivatively by the creditors or other stakeholders of the corporation, if the proper steps are taken. Section 239 of the CBCA permits a complainant to apply to a court for leave to bring an action in the name and on behalf of a corporation for the purpose of prosecuting the action on behalf of the corporate body.[146] The complainant may be a creditor, if considered by the court to be a proper person to make the application.

Which leaves open this question: Has *Peoples Department Stores* opened the floodgates for claims against directors or not? One suspects that the Supreme Court of Canada did not think it was opening the floodgates by denying a fiduciary duty to creditors and, although acknowledging a duty of care, relying on the Quebec Civil Code in order to make it actionable by a creditor. It made no accompanying common-law analysis. To the contrary, it stated that in light of both the availability of the oppression remedy and of an action based on duty of care (derivatively if not directly, other than in Quebec), there was no need from a policy point of view to give creditors more than they already have by expanding the more onerous statutory fiduciary duties of directors to creditors. The answer will be in the future application of the *Peoples Department Stores* case.

141. *Id.* at 488.
142. *Id.* at 487.
143. *Id.* at 475.
144. *Id.* at 487.
145. *Id.*
146. CBCA § 239.

III. ADVICE FOR DIRECTORS OF AN INSOLVENT COMPANY

Advice to directors of an insolvent business on either side of the border is the same. Directors have taken on the task of attempting to maximize the value of the firm. In doing so, they must act prudently and on a reasonably informed basis and in the best interests of the corporation, without conflict and without regard to any outside or personal interest of such director. Courts will not interfere with the proper exercise of business judgment.

Some may say this puts the bar quite low for director conduct. As long as a director is acting honestly and reasonably, and without conflict, his or her judgment need not be perfect. Deference to business judgment provides protection for errors in judgment, but does not shield directors from liability for lack of due diligence in the decision-making process.

Upon insolvency, or perhaps near insolvency, it is clear from an economic standpoint that in calling forth sufficient information to enable themselves to act in the best interests of the corporate enterprise itself on a reasonably informed basis, directors should strive to understand what is in the best interests of creditors, who in essence are the residual risk bearers of the corporation at that juncture. This is not to say that directors must pay heed only to what creditors desire; it is clear in Canada that no fiduciary duty is owed to the creditors, and in Delaware a fiduciary duty is owed to both stockholders and creditors. Understanding the realities of a company's economic situation and its options, however, is likely the key to business decision making during insolvency. Thus a director's duty of care to the corporate enterprise itself might well be judged by his or her understanding of the economic realities and the thought he or she gives to the range of options available to the corporation and their effect on all constituencies, including creditors.

When viewed in this light, the recognition in *Production Resources* of fiduciary duties to creditors of insolvent corporations and the rejection of such a concept in *Peoples Department Stores* should not affect the standard for corporate decision making in Delaware and Canada. Rather, the largest effect of *Production Resources* should be in after-the-fact litigation and determining who has standing to bring litigation. Standing is found in Canada through derivative claims and the oppression remedy and in Quebec, directly through the Civil Code. The great majority of such litigation is pursued after a bankruptcy case has been filed, by a trustee in bankruptcy for the benefit of the creditors. At such point, standing is typically no longer an issue.[147] As a result, the existence or nonexistence of a fiduciary duty to creditors is likely a distinction with no practical difference.

147. *See* Silberglied & Newmarch, *supra* note 73.