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BULLETIN

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FOCUS ON BUSINESS LAW

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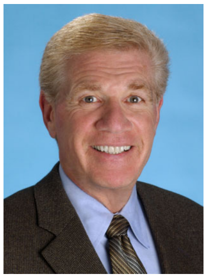
Do directors owe a fiduciary duty to creditors?



Barry A. Cohen, Q.C.

One of the growing concerns in Canadian corporate law for directors over the past several years has been: do directors owe a fiduciary duty to creditors when a corporation is in serious financial difficulty?

I wrote about this matter in our last newsletter, prior to the release by the Supreme Court of Canada of its decision on this issue, in late October 2004.

The Court held that directors do not owe a fiduciary duty to creditors, although they must take them into consideration in their decision-making process.

Readers may recall that in this case, the Quebec Court of Appeal held that the directors of a company in financial difficulty do not owe a fiduciary duty to the creditors of the corporation. The Trustee in Bankruptcy of Peoples Department Stores appealed that decision to the Supreme Court.

The Court upheld the decision of the Quebec Court of Appeal. The Supreme Court held that an honest attempt, in good faith, by the directors to deal with the corporation's financial difficulties, even if the result is not successful, does not constitute a breach of duty by the directors to the corporation.

Readers should be cautioned that this decision does not end the potential liability of directors to creditors. Nothing in this decision changes the existing obligations of directors and officers to act in good faith and honestly vis-à-vis the corporation. Directors must exercise the required degree of due diligence and act in a careful manner in order to fulfil their fiduciary duties to the corporation.

When a corporation is on the brink of insolvency, the value of shareholders' equity will diminish and, on bankruptcy, will be of no value. On the other hand, in these circumstances, creditors' claims will be of significant importance.

The Court observed that creditors already have certain rights – such as oppression claims – if they perceive abusive conduct by the corporation or its directors. If directors act in an honest, diligent manner, with a view to the best interests of the corporation, there should be no basis for a successful claim for breach of their fiduciary duties.

While there is one fewer smoking gun aimed at directors, they must continue to be cautious that they exercise business decisions on a reasonably-informed basis and that the decision-making process is sufficiently documented. The Courts will objectively review whether the appropriate degree of prudence and diligence has been applied to the decision-making process, and directors must keep this in mind at all times. This is all the more important in insolvency situations where corporations do not carry director-liability insurance, or it has lapsed.

In an era of ever-increasing demands for accountability, directors must be careful both to act in the best interests of the corporation and also to ensure that they record the basis for decisions in order to insulate themselves from successful claims against them. Directors must be aware that creditors, having had this door closed to them, will consider resorting to corporate oppression and like remedies in order to minimize their losses. Directors must continue to keep these issues in mind when acting on behalf of a corporation, failing which the results may be less than happy.

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