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• DIRECTORS AND CREDITORS IN THE “ZONE OF INSOLVENCY” •

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The Delaware Supreme Court’s recent decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*¹ addresses the fiduciary duties of corporate directors in Delaware. In affirming a lower court decision by the Delaware Court of Chancery,² the Delaware Supreme Court held that creditors of a Delaware corporation that is insolvent or in the “zone of insolvency” have no right to bring direct claims for breach of fiduciary duty against directors. This result may seem familiar to observers of the Canadian legal scene, as it resembles the Supreme

Court of Canada’s decision in *Peoples Department Store Inc. v. Wise*³ in many respects. However, the differences between the judgments are consequential with implications for corporate directors on both sides of the border.

GHEEWALLA

The plaintiff, North American Catholic Educational Programming Foundation, Inc. (“NACEPF”), held Federal Communication Commission (FCC)-approved radio wave spectrum licences. The defendants were employees of Goldman Sachs & Co. (“Goldman Sachs”) who served on the Clearwire Holdings, Inc. (“Clearwire”) board of directors (the “Goldman Directors”). In March 2001, Clearwire and NACEPF entered into an agreement whereby Clearwire was obligated to acquire NACEPF’s FCC licences when they became available. At the time the agreement was signed, Clearwire had some liquidity issues and the Goldman Directors allegedly knew that Goldman Sachs’s investment objectives had changed and that it did not intend to provide Clearwire with additional capital.

Following the collapse of the wireless spectrum market, Clearwire effectively went out of business in October 2003. NACEPF subsequently filed a complaint as a creditor that alleged direct fiduciary duty claims against the Goldman Directors. NACEPF alleged that: (1) Clearwire was either insolvent or in the

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“zone of insolvency” at all relevant times; (2) the Goldman Directors controlled Clearwire by virtue of their affiliation with Goldman Sachs, which was Clearwire’s exclusive source of financing; and (3) the Goldman Directors owed fiduciary duties to NACEPF as a creditor of Clearwire.⁴

The NACEPF also alleged that the Goldman Directors failed to exercise their fiduciary duties by (1) not preserving the assets of Clearwire for the benefit of creditors when it was apparent that Clearwire would not continue as a going concern; and (2) holding on to the FCC licence rights solely to keep Goldman Sachs’s investment “in play”, knowing that Clearwire would not use them.⁵

The Court of Chancery ruled that: (1) creditors of a Delaware corporation in the “zone of insolvency” can not assert direct claims for breach of fiduciary duty against the corporation’s directors; and (2) the complaint failed to state a claim for the narrow, if extant, cause of action for direct claims involving breach of fiduciary duty brought by creditors against directors of insolvent Delaware corporations.⁶ The NACEPF subsequently appealed this decision to the Delaware Supreme Court.

In affirming the judgment of the Court of Chancery, the Supreme Court framed the key issue by asking if, “...the creditor of a corporation that is operating within the zone of insolvency [can] bring a direct action against its directors for an alleged breach of fiduciary duty?”⁷ The Court’s answer “that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency”⁸ is definitive and closed the door on a potential direct action that had remained a theoretical possibility based on dicta from prior Delaware case law.⁹

In its reasons, the Court cited the adequate creditor protections already in place and the necessity of providing directors with certainty regarding the exercise of business judgment in the zone of insolvency. The Court stated that:¹⁰

While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.

The Court found that sufficient creditor protection already exists in the commercial sphere and that an

additional layer of protection in the form of a direct claim against directors for breach of fiduciary duty by creditors is unnecessary.¹¹ The Delaware Supreme Court also cited the Court of Chancery's analysis that "any benefit to be derived by the recognition of such additional direct claims appears minimal, at best, and significantly outweighed by the costs to economic efficiency".¹²

In addition, the Court noted its intention to provide directors with "clear signal beacons and brightly lined channel markers"¹³ that "mark the safe harbors clearly"¹⁴ so that they may exercise their duties to the corporation with some degree of certainty of purpose. The Court held that:¹⁵

When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

The desire of the Court to provide directors with definitive guidance and to eliminate uncertainty is apparent. By finding that "[d]irectors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation",¹⁶ the Court recognized that the finding of an additional fiduciary duty to creditors could act as a freeze on the actions of directors and create another potential pitfall in the zone of insolvency.

Creditors, however, are left with some recourse. The Delaware Supreme Court reiterated the existence of derivative claims available to creditors. The Court stated that "creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties"¹⁷ and that "creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent".¹⁸ Therefore, "[t]he fact that the corporation has become insolvent does not turn [derivative] claims into direct creditor claims, it simply provides creditors with standing to assert those claims".¹⁹

The Court explained the nature of these claims by noting that improper actions by directors when the firm is insolvent "operate to injure the firm in the first instance by reducing its value, injuring creditors only

indirectly by diminishing the value of the firm and therefore the assets from which the creditors may satisfy their claims".²⁰ Thus, the claims are derivative as opposed to direct in nature.

This approach of balancing the interests of the corporation's various stakeholders resembles the approach taken by the Supreme Court of Canada in *Peoples* in certain, but not all, respects.

PEOPLES

In 1992, Wise Stores Inc. ("Wise") acquired Peoples Department Stores ("Peoples"), which became a wholly-owned subsidiary of Wise. The directors of Wise consisted solely of the Wise brothers ("Wise Directors"). The entire retail operation was plagued by poor financial results and the Wise Directors implemented a joint inventory procurement program in an attempt to turn things around. When the turnaround failed to materialize, Wise and Peoples declared bankruptcy. A by-product of the procurement program was a \$4.44 million debt owed by Wise to Peoples.

As a result, Peoples' trustee in bankruptcy sued the Wise Directors. The trustee claimed that they favoured the interests of Wise over Peoples to the detriment of Peoples' creditors, thereby breaching their duties as directors under the *Canada Business Corporations Act* ("CBCA").²¹

At trial, the Québec Superior Court held that directors' fiduciary duty under the CBCA does, in fact, extend to creditors when a company is approaching insolvency and awarded the trustee \$4.44 million in damages.²² The Court of Appeal for Quebec reversed this decision,²³ and the case was subsequently heard by the Supreme Court of Canada on appeal.

The Supreme Court of Canada held that directors owe no fiduciary duty to creditors under the CBCA. In a decision that dealt with several corporate governance issues relevant to directors, the Court covered much of the same ground as the Delaware Supreme Court in *Gheewalla* regarding the fiduciary duty of directors to creditors in the "vicinity of insolvency".²⁴

The Court held that: "[a]t all times, directors and officers owe their fiduciary obligation to the corporation [and that the] interests of the corporation are not to be confused with the interests of the creditors..."²⁵ In addition the "directors' fiduciary duty does not change when a corporation is in the nebulous 'vicinity of insolvency'"²⁶ and "[t]here is no need to read the

interests of creditors into the [fiduciary] duty set out in ... the CBCA".²⁷

In explaining its judgment, the Court acknowledged the potential dichotomy for directors of a corporation in the vicinity of insolvency between shareholders who would prefer an aggressive strategy designed to save the corporation on a going concern basis versus creditors who would prefer a more conservative approach that safeguards the assets of the corporation and allows for greater realization of debts.²⁸ The Court provided directors with the following advice:²⁹

In using their skills for the benefit of the corporation when it is in troubled waters financially, the directors must be careful to attempt to act in its best interests by creating a 'better' corporation, and not to favour the interests of any one group of stakeholders.

No doubt, Canadian directors would be comforted by the Supreme Court of Canada's judgment and reasons if they stopped reading here. The decision, however, went on to identify other remedies for aggrieved creditors to pursue. Specifically, the Court cited the availability of the oppression remedy as well as an action based on the duty of care as alternatives for creditors to pursue in Canada.³⁰ As the Supreme Court did not have an oppression claim before it, its decision did not fully articulate the extent of this remedy with respect to creditors. The Court did, however, outline the contents of the duty of care owed by directors to creditors. It is with respect to this alternative that the Supreme Court of Canada's decision diverged with the Delaware decision and where Canadian directors must tread carefully. The Court held that under the CBCA, "...the identity of the beneficiary of the duty of care is much more open-ended, and it appears obvious that it must include creditors".³¹

Although the Supreme Court ruled that the Wise Directors did not breach their duty of care to creditors, it was expressly recognized that the interests of creditors become more relevant when a corporation's financial condition deteriorates.³² Significantly, the Supreme Court of Canada also approved use of the "business judgment rule" in assessing whether directors have fulfilled the duty of care, meaning that directors must make reasonable business decisions on a prudent and informed basis and that second-guessing of these decisions by Canadian courts should be avoided.³³ This

analysis formally brought Canadian law in line with American jurisprudence on the subject.

Despite the protection afforded by the business judgment rule, the Supreme Court injected some additional uncertainty into the decision-making processes of Canadian directors. Due to the tension between shareholders and creditors when a corporation approaches the vicinity of insolvency, the directing minds of companies operating in distress will have to contend with a difficult balancing act.

MOVING FORWARD

Whereas the Delaware Supreme Court made certainty for directors a hallmark of its decision in *Gheewalla*, the Supreme Court of Canada had other priorities in *Peoples*. Like the Delaware court, the Supreme Court of Canada held that directors of Canadian companies do not owe fiduciary duties to creditors of a corporation even when the corporation is in the "vicinity of insolvency". However, the finding that the duty of care is broad and may extend to creditors was significant and contrary to the commonly held view that a director's fiduciary duty and duty of care are owed solely to the corporation. The end result is that in an insolvency context, where the interests of a corporation and its creditors are most likely to diverge, directors may find themselves navigating through a thicket of potential conflicts.

Effective August 2007, the Ontario *Business Corporations Act* ("OBCA")³⁴ was amended to expressly state that directors and officers owe their fiduciary duty and duty of care only to the corporation.³⁵ There is little question that this change to the OBCA was made in response to the *Peoples* decision in order to alleviate some uncertainty and provide clearer direction to boards of directors. It remains to be seen whether or not other provinces will follow suit.

Moving forward, directors of Canadian corporations operating in the vicinity of insolvency would do well by continuing to take into consideration the interests of all stakeholders, especially those of creditors. The potential actions for breach of the duty of care and the oppression remedy remain potent weapons for aggrieved creditors to wield against boards of directors. U.S. directors can breathe a sigh of relief because direct claims for breaches of fiduciary duties may not be asserted in Delaware by creditors. However, derivative claims are available to creditors. On a practical level, any recoveries under these actions are

for the benefit of the insolvent corporation run by the very directors being implicated in the action. As a result, these claims are of limited value to creditors seeking recourse against directors of insolvent or near-insolvent corporations. Nevertheless, corporate governance best practices continue to encourage directors on both sides of the border to maintain a heightened sensitivity to creditor-related issues, especially when the corporation is operating within the vicinity of insolvency.

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¹ 2007 Del. LEXIS 227, 930 A.2d 92 (Del. Sup. Ct.) [*"Gheewalla"*].
² 2006 Del. Ch. LEXIS 164, 2006 WL 2588971 (Del. Ch.).
³ [2004] S.C.J. No. 64 (QL), [2004] 3 S.C.R. 461 [*"Peoples"*].
⁴ *Gheewalla, supra*, note 1, at 93-94.
⁵ *Ibid.*, at 95.
⁶ *Ibid.*, at 94.
⁷ *Ibid.*, at 99.
⁸ *Ibid.*, at 101.
⁹ *Ibid.*, at 103.

¹⁰ *Ibid.*, at 99.
¹¹ *Ibid.*, at 100.
¹² *Ibid.*, at 100.
¹³ *Ibid.*, at 101.
¹⁴ *Ibid.*
¹⁵ *Ibid.*
¹⁶ *Ibid.*, at 103.
¹⁷ *Ibid.*, at 101.
¹⁸ *Ibid.*, at 102.
¹⁹ *Ibid.*
²⁰ *Ibid.*
²¹ R.S.C., 1985, c. C-44, s. 1 [*"CBCA"*].
²² [1998] Q.J. No. 3571 (QL), 23 C.B.R. (4th) 200 (S.C.).
²³ *Peoples Department Stores Inc. (trustee of) v. Wise*, [2003] Q.J. No. 505 (QL), 41 C.B.R. (4th) 225 (C.A.).
²⁴ This term may be used interchangeably with "zone of insolvency".
²⁵ *Peoples, supra*, note 3, at para. 43.
²⁶ *Ibid.*, at para. 46.
²⁷ *Ibid.*, at para. 53.
²⁸ *Ibid.*, at para. 45.
²⁹ *Ibid.*, at para. 47.
³⁰ *Ibid.*, at para. 53.
³¹ *Ibid.*, at para. 57.
³² *Ibid.*, at para. 49.
³³ *Ibid.*, at para. 67.
³⁴ R.S.O. 1990, c. B.16 [*"OBCA"*].
³⁵ OBCA, s. 134(1)