LANDMARK CASE

PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE

CURRICULUM LINKS:
Canadian and International Law, Grade 12, University Preparation (**CLN4U**)

Understanding Canadian Law, Grade 11, University/College Preparation (**CLU3M**)

ESTIMATED TIME:
1 - 2 periods

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DIRECTORS' DUTIES TO CREDITORS: PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE

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- Classroom discussion questions
- A glossary of key terms
- Student worksheets
- Cooperative learning activities
- Ideas for extension exercises

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PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE, (2004) 3 S.C.R. 461, 2004 SCC 68

FACTS

This case involves two companies, Peoples Department Stores Inc. and Wise Stores Inc. Peoples was fully owned by Wise (therefore making Peoples a subsidiary). The Wise Brothers, Lionel, Ralph, and Harold, became the only shareholders of Peoples, and they owned 75% of the shares of Wise. The Wise brothers were also the directors for both companies and therefore conducted the daily management of the companies.

In 1994, both companies began to struggle financially and did not have enough money to continue to operate. To cut down on costs, the Wise brothers developed a strategy on the advice of an outside professional, where certain inventory would be purchased through Peoples and then given to Wise on credit. Soon, Wise owed more than 18 million dollars to Peoples. By 1995, both Wise and Peoples declared bankruptcy. Once bankruptcy was declared, a trustee was appointed to take control of the businesses and attempt to pay back the various creditors.

The trustee claimed that while the Wise brothers

BANKRUPTCY AND INSOLVENCY ACT

***EXAMINATION OF CONSIDERATION IN A REVIEWABLE TRANSACTION**

100. (1) Where a bankrupt sold, purchased, leased, hired, supplied or received property or services in a reviewable transaction. . .the court may, on the application of the trustee, inquire into whether the bankrupt gave or received, as the case may be, fair market value in consideration for the property or services concerned in the transaction.

JUDGMENT FOR DIFFERENCE

(2) Where the court in proceedings under this section finds that the consideration given or received by the bankrupt in the reviewable transaction was conspicuously greater or less than the fair market value of the property or services concerned in the transaction, the court may give judgment to the trustee against the other party to the transaction, against any other person being privy to the transaction with the bankrupt or against all those persons for the difference between the actual consideration given or received by the bankrupt and the fair market value, as determined by the court, of the property or services concerned in the transaction.

* Section 100 was repealed in 2005 and no longer appears within the *Bankruptcy and Insolvency Act*.

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were running the business, they took actions that were better for Wise and harmful to Peoples and its creditors. The trustee also claimed that in the year before the bankruptcy, the brothers performed some transactions that should be reviewed. They had transferred assets from Peoples to Wise at a price that was much less than what the assets were actually worth (known as the fair market value). As a result, the trustee claimed that the directors made a deal that was not reasonable, given that the assets were transferred at a price that was significantly below the fair market value, as required by s. 100 of the *Bankruptcy and Insolvency Act (BIA)*.

The creditors for Peoples brought an action against the Wise brothers, claiming that the Directors breached their fiduciary duty and duty of care under section 122(1) of the *Canada Business Corporations Act* (*CBCA*).

CANADA BUSINESS CORPORATIONS ACT

DUTIES OF DIRECTORS AND OFFICERS

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 (fiduciary duty); and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. (duty of care)

ISSUES

1. Did the Wise Brothers breach their duties under section 122(1) of the *CBCA*, by making decisions that were better for Wise but harmful to Peoples and its creditors?

2. Do the fiduciary duty and duty of care outlined in s. 122(1) of the *CBCA* apply to the creditors as well, or only the corporation? (Recall that the trustee was bringing a claim for the creditors who were owed money by Peoples)

3. Were the transactions involving the transfer of assets between Peoples and Wise in violation of S. 100 of the *BIA*?

JUDICIAL HISTORY

At trial, the Quebec Superior Court found that the Wise Brothers had breached their fiduciary duty and duty of care and awarded the trustee $4.44 million in damages. The court held that the directors' fiduciary duty extends to creditors when a company is approaching insolvency, and that the transfer of assets at a value below their fair market value did not comply with s. 100 of the *BIA*.

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CASE SUMMARY

The Wise Brothers appealed to the Quebec Court of Appeal, which reversed the trial decision and found that the Wise brothers did not breach their duties under s. 122(1) of the *CBCA*, and that the transactions in question were not in violation of s. 100 of the *BIA*. The decision was appealed to the Supreme Court of Canada (SCC).

DECISION OF THE SUPREME COURT OF CANADA

In a unanimous decision, the SCC found that the directors did not owe a duty to the creditors under s. 122(1), and dismissed the appeal. The directors owe a fiduciary duty and a duty of care to the corporation and as such, the Wise brothers did not breach their duties under s. 122(1) of the *CBCA*.

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

When examining the fiduciary duty placed on directors in s. 122(1)(a), the court found that in this case the decisions were made by the Wise brothers while the corporations were struggling financially. Since they were almost at a stage of bankruptcy, their goals were to try to prevent the bankruptcy and resolve the problems which both corporations were facing. Since their intentions were to do things that would help the company as much as possible and try to make the company survive, the decisions were found to be in the best interests of the corporation. This means that the directors acted honestly and loyally to the corporation and did not breach their fiduciary duty under s. 122(1)(a).

The court made it clear that the best interests of the corporation should not be confused with the interests of the creditors, or those of any other

DUTIES OF DIRECTORS AND OFFICERS

FIDUCIARY DUTY:

It is the duty of the directors and officers of a corporation to act in a manner that is honest and loyal to the corporation. This is called the Fiduciary Duty. For example, directors should not make decisions that would be harmful to the corporation or conduct fraud which would harm the corporation. The law requires this duty of the directors under subsection 122 (1) (a).

DUTY OF CARE:

When making business decisions, the directors and officers also owe what is called in law a duty of care. This means that directors have to make informed decisions that are good for the company, after having gathered all available information. For example, if the directors are planning to buy some equipment, they have to make sure that they have properly researched the suppliers, made sure that the equipment will improve the business and only buy it if there is enough money. The law requires this duty of the directors under subsection 122 (1)(b).

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CASE SUMMARY

stakeholders. When the business is running well and is profitable, the interests of the corporation, shareholders and the creditors will all be the same -- to ensure that the company continues to make a profit. However, when the business is in trouble, the interests of the company change, and the goal is to make sure that the company does not have any more losses. At this point, the shareholders are worried about the value of their shares, the creditors are worried about being paid back, and so the interests of the various stakeholders are no longer the same. It is the duty of the directors under s. 122(1)(a) of the *CBCA* to make sure that interests of the corporation are what are addressed first.

Therefore, the directors of the corporation did not owe a fiduciary duty to the creditors of the company, and the Wise Brothers did not breach their fiduciary duty.

Duty of Care: Section 122(1)(b) of the *CBCA*

The SCC affirmed the "business judgment rule" with respect to the directors' duty of care. This refers to the tendency of courts not to second-guess the business decisions of directors, who are recognized to have significant expertise in running a business, if the court determines that the directors' decisions were reasonable at the time they were made. However, courts will determine if directors followed the proper procedures in making the decisions by checking to see if they made informed, rational decisions. In this case, the SCC found that the directors did not breach their duty of care with respect to Peoples' creditors. The decision made by the directors was a reasonable business decision at the time, which was aimed at fixing a serious and urgent business problem in circumstances of financial difficulty.

For those who challenge the business decisions of directors, the law requires that they prove that the directors acted (i) in breach of the duty of care and (ii) in a way that caused injury. Directors and officers will not be found to have breached the duty of care under s. 122(1)(b) if they acted reasonably and on an informed basis, taking into account all the circumstances that they knew about or should have known about.

Duty of Care: Section 122(1)(b) of the *CBCA*

The SCC found that the Wise Brothers were in violation of s. 100 of the *BIA*. In analyzing the transactions, the court found that the difference between the fair market value and the amount the company received for the assets was 6%. This

was not considered to be enough of a difference to constitute a "conspicuous" difference under s. 100 of the *BIA*.

CONCLUSION

The court affirmed that directors must act in the best interests of the corporation, and in doing so, may consider the interests of various affected groups, including shareholders and creditors, but are not required to do so. Ultimately, the directors must act in the best interests of the corporation and its operations. The role of the court is not to second guess the business decisions of the directors, but rather to ensure that a legally sound decision making process was followed.

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CLASSROOM DISCUSSION QUESTIONS

1. Name 5 possible stakeholders of a corporation.

2. What are the 2 duties owed by directors and what statute imposes this duty on them?

3. Do corporate directors owe a duty to creditors as stated in s. 122(1)?

4. Under s. 122(1), who do directors owe a duty of care to?

5. What is considered to be "in the best interest of the corporation"?

6. Do you agree with the decisions of the SCC? Why or why not? Was it a fair decision?

7. Why do you think the courts implement the business judgment rule? Why would they be reluctant to second guess business decisions?

8. How could the decision reached by the SCC affect the role of directors of other Canadian corporations?

9. Do you think directors of corporations should have to equally balance the interests of the corporation, the shareholders and the creditors when facing financial difficulty? Why or why not?

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PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE: ACTIVITY 1

Section 122(1) of the Canadian Business Corporations Act (*CBCA*) outlines the duties of directors and officers of corporations.

In other words, the fiduciary duty requires directors to act in a way that is loyal, in good faith and honest to the corporation. The duty of care requires directors to make sensible and well informed decisions.

Review the scenarios below and indicate if the directors breached their duties in the space provided.

CANADA BUSINESS CORPORATIONS ACT

DUTIES OF DIRECTORS AND OFFICERS

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 (fiduciary duty); and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. (duty of care)

STUDENT RESOURCES

EXAMPLE

SCENARIO	FIDUCIARY DUTY	DUTY OF CARE
Corporation A decided to buy Corporation B. Before buying the company, the directors of Corporation A conducted a thorough investigation of Corporation B and found that they had taken some actions that could be considered fraudulent, and which could seriously harm the reputation of Corporation A. However, if the deal went through, the directors would stand to personally profit from the sale. Even though it would serve as a huge risk to A, the directors decided to continue with the deal.	The decision made by the directors was not in good faith and did not meet the best interest of the corporation. Buying a company that could cause serious harm to the reputation of A is not in the best interests of A. The directors decided to buy the company because it would profit them, and not the company. As such, the directors breached their fiduciary duty for not being honest and loyal in the purchase of B.	The directors properly conducted their research of the other company in the early stages, and therefore would be considered to have all the necessary information to make a reasonable decision. However, their decision to buy the business after they learned the information is not a decision that a reasonable person would make in the same situation. Knowing that it could damage company A, but continuing regardless, would be a breach of their duty of care.

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PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE: ACTIVITY 1

SCENARIO	FIDUCIARY DUTY	DUTY OF CARE
1. After doing research, directors of a company determined that a property owned by the corporation was steadily declining in value and not worth a lot to the corporation. The directors agreed to sell the property and, in exchange, the purchaser agreed to provide a financial bonus to the directors for ensuring that the transaction was complete.		
2. Directors made payments to creditors while there were insufficient funds to continue running the business.		
3. Directors purchased a piece of land that would be a valuable asset to the corporation in the future. A few years later, due to bad market conditions, the land is worthless.		
4. Directors agreed to invest a substantial sum of money in another company, which resulted in a huge loss to their business. The decision was made after brief inquiries were made about the business affairs of the company in which they were investing. The directors received no personal benefit from this transaction, but thought that the corporation would greatly benefit from this investment.		

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PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE: ACTIVITY 2

Hold a class debate on the debate proposition below. This can be done in small groups or by dividing the entire class in half. Prepare your arguments and anticipate those of the opposing side. Prepare questions and rebuttals accordingly.

Debate Proposition: When a business is in financial difficulty, the directors of the corporation should make business decisions based on what is in the best interests of the corporation.

Debate Structure: One team argues in support of the proposition and one team against it.

1. The supporting position presents their arguments (5-7 minutes)
   - Give a good introduction that gets the opposing team's interest and attention
   - State your main points, giving evidence and reasoning for your arguments
   - Give a strong conclusion
2. The opposing position questions the supporting position (3-5 minutes)
   - Ask questions about the supporting team's position
   - Prepare questions to challenge them in advance
3. The opposing position presents their arguments (5-7 minutes)
   - Give a good introduction that gets the supporting team's interest and attention
   - State your main points, giving evidence and reasoning for your arguments
   - Question the supporting position
   - Give a strong conclusion
4. The supporting position questions the opposing position (3-5 minutes)
   - Ask questions about the opposing team's position
   - Prepare questions to challenge them in advance

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5. The supporting position presents their rebuttal (5 minutes)
    - Restate and strengthen your position
    - Identify how your argument is stronger than the opposing position
    - Summarize your case and give a strong conclusion
6. The opposing position presents their rebuttal (5 minutes)
    - Restate and strengthen your position
    - Identify how your argument is stronger than the supporting position
    - Summarize your case and give a strong conclusion

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SCENARIO	FIDUCIARY DUTY	DUTY OF CARE
1. After doing research, directors of a company determined that a property owned by the corporation was steadily declining in value and not worth a lot to the corporation. The directors agreed to sell the property and, in exchange, the purchaser agreed to provide a financial bonus to the directors for ensuring that the transaction was complete.	The directors are breaching their fiduciary duties by taking a bonus to make the transaction happen. Their actions are not honest nor loyal to the corporation; rather they had a personal interest in making sure the transaction occurred.	The transaction did not breach the duty of care since the decision was thought out properly and found to be a good decision for the business to sell the property. The directors acted reasonably and rationally and they made a well informed decision.
2. Directors made payments to creditors while there were insufficient funds to continue running the business.	There was a breach of fiduciary duty. There is no duty owed to creditors and therefore the decision to favour the creditors over the corporation would be a breach of the fiduciary duty.	There was a breach of duty of care. This decision was not reasonable and not well informed and therefore would also be a breach of the duty of care that is owed to the corporation.
3. Directors purchased a piece of land that would be a valuable asset to the corporation in the future. A few years later, due to bad market conditions, the land is worthless.	When buying the land, the directors acted in good faith and in a manner loyal to the company. They made a decision to purchase the land with the intention that the transaction would be in the best interests of the corporation. Therefore, they would not be in breach of their fiduciary duty.	The decision at the time that it was made was well informed and reasonable, and therefore not in breach of the directors' duty of care. According to the business judgment rule, the court will not judge the decision based on the outcome; rather they will determine if the decision was reasonable at the time that it was made.

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PEOPLES DEPARTMENT STORES INC. (TRUSTEE OF) v. WISE: ACTIVITY 1 - ANSWER KEY

SCENARIO	FIDUCIARY DUTY	DUTY OF CARE
4. Directors agreed to invest a substantial sum of money in another company, which resulted in a huge loss to their business. The decision was made after brief inquiries were made about the business affairs of the company in which they were investing. The directors received no personal benefit from this transaction, but thought that the corporation would greatly benefit from this investment.	Since the directors acted in good faith and honestly, there is no breach of fiduciary duty. The directors did not personally benefit from the transaction and believed that the investment was in the best interest of the corporation, therefore they acted in good faith.	The directors breached their duty of care since they did not attempt to properly inform themselves of the affairs of the company they were considering. They did not act responsibly or diligently.

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