Directors' Charges Under the CCAA: Where are we Going and Why?

By Fred Myers and Peter Kolla[1]

1) Introduction

On September 29, 2008, the S&P 500 suffered its largest one day drop since 1987, while the intraday point decline of the Dow Jones industrial average was the largest ever.[2] Though the Dow Jones surged on October 13th to post its biggest one day point gain ever, those gains were preceded by a week where it lost 18 percent of its value.[3] In Canada, during the last two weeks of September and the first week of October, the S&P/TSX Composite Index lost 6.1 percent, 10.9 percent, and 16.1 percent, of its value respectively.[4] Such calamity does not bode well for the financial health of companies in North America, especially when the failure of financial institutions around the globe – Lehman Brothers' petition for Chapter 11 protection being only the most sensation example – could potentially cause a "full-blown credit crunch."[5]

Unfortunately it appears inevitable that due to these events and the struggles that businesses face every day, companies that are viable, but lack liquidity, will soon become insolvent and will seek to be restructured. The question of how to keep the members of a company's board of directors from resigning before a restructuring process begins is an important and perennial issue. With the collapse in financial markets and the related tumble in the stock markets in September and October 2008, it is an especially topical one.

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[2] Krishna Guha *et al*. "Stocks dive on bail-out rejection" *The Financial Times* (30 September 2008) 1.

[3] Janet Whitman "Dow posts largest yet one-day gain" *The National Post* (14 October 2008) 1. The Dow's 11 percent gain on October 13, 2008 was the largest percentage gain since a 15.34 percent gain on March 15, 1933.

[4] Data from the website of *The Financial Times*, accessed October 15, 2008: online, The Financial Times <www.ft.com>.

[5] Krishna Guha & Alan Beattie "Federal saviours for a system in distress" *The Financial Times* (2 October 2008) 3.

During the restructuring of a company, amidst the myriad of challenges, the company greatly benefits from the leadership by a board of directors that is committed to the success of the business and is knowledgeable about how to achieve that success. But it is difficult for companies to retain the services of the incumbent board of directors during a restructuring because the individual board members can face personal liability as a result of circumstances that may be beyond their control. In some cases, this liability can occur without the directors committing personal wrongs. Yet, experience shows that absent fraud or other types of misfeasance on the part of board members, keeping the board of directors in place during a restructuring can be a crucial element to successfully restructuring insolvent companies. The directors' charge is one tool to induce incumbent directors to retain their positions during a restructuring so that they can lead the efforts to rehabilitate a company's fortunes. The directors' charge can be defined as a court ordered super-priority security interest against the debtor's assets that can be created in an initial order made under the *Companies' Creditors Arrangement Act* (the "*CCAA*").[6]

The directors' charge is an important topic, due in part to the recently proposed statutory amendments to the *CCAA*, some of which concern directors' charges.[7] Practically, there are many considerations that should go into a court's discretionary decision of whether to grant a directors' charge and these considerations often do not get the attention they deserve in the tumultuous times that surround the filing of an application under the *CCAA*. These considerations include concerns over the scope of a directors' charge, such as how the charge compliments directors' insurance coverage and whether the directors' charge should cover liabilities incurred prior to the *CCAA* restructuring process. Since the directors' charge interferes with existing rights of other stakeholders, another important consideration is the scope of interfering with these rights while allowing the *CCAA* to continue. Given the fact-driven nature of *CCAA* restructurings, there are no correct answers to these questions. However, there are ways to find the correct answer to these questions that fit the particular facts of each restructuring, and such a process can ultimately help a company successfully restructure.

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[6] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-25.

[7] Bill C-62, *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, 1st Sess, 39th Parl., 2007, cl. 66 (Third Reading June 14, 2007).

Section 2 of this paper begins with an analysis of the importance of directors to restructurings. Sections 3 and 4 concern the difficulties faced by directors due to a company's insolvency, with respect to the duties they owe and the liabilities they face. It is these difficulties that can prompt directors to resign. Directors have certain statutory protections, which is the topic of section 5. Defining the directors' charge and exploring the jurisdiction of courts to grant charges are the topics of sections 6 and 7, respectively. These preceding sections will, it is hoped, provide a sufficient foundation so that the discussion in sections 8 and 9 as to the proper scope of directors' charges and how directors' charges ought to be employed in practice are useful to readers.

2) The importance of directors to restructurings

The *CCAA* is the principal Canadian legislation that permits the restructuring of financially-troubled but viable companies. The *CCAA* is remedial legislation that will be liberally construed to fulfill its purpose as set out in the *CCAA*'s preamble: "An Act to facilitate compromises and arrangements between companies and their creditors."[8] Such a flexible piece of legislation can allow many actors to play important roles in facilitating these "compromises and arrangements".[9] However, among all these actors, the directors of a company are often collectively the lynchpin to a successful restructuring.

The centrality of the role of directors in a *CCAA* restructuring is due to the fact that it is the debtor companies themselves that lead the restructuring efforts. Creditors, and of course the

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[8] *Metcalfe & Mansfield Alternative Investments II Corp., (Re)*, 2008 ONCA 587 at para. 44; Kevin P. McElcheran, *Commercial Insolvency in Canada* (Markham: LexisNexis, 2005) at 8.

[9] Others, of course, can perform key roles as well. For example, the court-appointed monitor, which is authorized pursuant to section 11.7 of the *CCAA*, has evolved from playing a passive role into an active and important participant in the restructuring process. Monitors' powers can be enhanced when there is reason to place responsibility for aspects of a restructuring process into the hands of an independent officer: David Mann & Neil Narfason, "The Changing Role of the Monitor" (2008) 24 B.F.L.R. 131; see also the comment of Farley J. in *Air Canada, Re* (2003), 42 C.B.R. (4th) 173 at para. 3 (Ont. S.C.J. (C.L.)). A chief restructuring officer, although not mandatory, is often a crucial actor when the existing management is not able to handle the particularized challenges of a reorganization: Robin B. Schwill, "Good Stewardship in Bad Times" (2008) 24 B.F.L.R. 151 at 162-63. Our assumption is that in the ordinary course and absent a reason for stakeholders to suffer a loss of confidence in corporate leadership, the stability of the restructuring is best left in the hands of the board of directors and management.

courts, are also essential to every *CCAA* restructuring.[10] However, in the normal course, the burden of returning a company to financial health falls squarely upon the insolvent company's managers and directors. Understanding the tools that are available to keep directors from resigning, such as directors' insurance, indemnities and directors' charges, can assist in maintaining the stewardship of incumbent board members as an essential component of a successful restructuring under the *CCAA*.

CCAA restructurings, if successful, are not simply good for companies, but are good for a whole host of stakeholders. It follows that if retaining the incumbent board during the restructuring can help the company, it can help stakeholders too. Suppliers are often anxious to retain the debtor's business; a debtor benefits from maintaining its source of supply.[11] Although employees are obviously impacted, and these impacts often include job losses, when compared to liquidations under the *Bankruptcy and Insolvency Act*[12] the restructuring of large companies under the *CCAA* generally allows for wages to be paid and at least some pension contributions to be paid going forward.[13] There can also be a broader public interest at stake in a restructuring, a point made crystal clear by Blair J.A. in the recent decision affirming the restructuring involving the Canadian asset backed commercial paper market:

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[10] Creditors especially have a central role in a restructuring, as they must agree to any arrangement. If creditors lose confidence in management, they can seek to terminate the process or they can seek alternatives such as the appointment of a chief restructuring officer, enhanced monitor powers, or the appointment of an interim receiver: McElcheran, *supra*, note 8 at 17-22.

[11] E. Patrick Shea, "Dealing with Suppliers in A Reorganization" (2008) 37 C.B.R. (5th) 161 at 161.

[12] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.

[13] Wage arrears in bankruptcy are more common than arrears in a restructuring. It is generally accepted that wage arrears will create so much stress on the workforce that it will undermine restructuring efforts. The Ontario Template Initial Order, discussed *infra*, allows for payment of wage arrears in a *CCAA* proceeding even though such payments might be preferential as compared to claims of other creditors that are stayed upon the commencement of the proceeding. However, it is common for jobs to be lost during a *CCAA* proceeding. Employee claims for termination pay and severance pay continue to be treated as unsecured claims that are subject to compromise. In addition, despite amendments in the recently proclaimed *Wage Earner Protection Program Act*, S.C. 2005, c. 47, s. 1 (Canlii), only limited protection has been provided to wage arrears, if any, and for unpaid pension contributions. In view of the very personal harm suffered by employees upon losing their jobs, and in light of the limits on the statutory protection of their claims, employees remain a particularly vulnerable class of stakeholder in insolvency proceedings. For a more detailed treatment of these issues, see David E. Baird & Ronald B. Davis, "Labour Issues" in Stephanie Ben-Ishai & Anthony Duggan, eds., *Canadian Bankruptcy and Insolvency Law: Bill C-55, Statute c.47 and Beyond* (Markham: LexisNexis, 2007) 68.

> The remedial purpose of the CCAA – as its title affirms – is to facilitate compromises or arrangements between an insolvent debtor company and its creditors. In *Chef Ready Foods Ltd. v. Hongkong Bank of Canada*, Gibbs J.A. summarized very concisely the purpose, object and scheme of the Act:
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>> Almost inevitably, liquidation destroyed the shareholders' investment, yielded little by way of recovery to the creditors, and exacerbated the social evil of devastating levels of unemployment. The government of the day sought, through the C.C.A.A., to create a regime whereby the principals of the company and the creditors could be brought together under the supervision of the court to attempt a reorganization or compromise or arrangement under which the company could continue in business.
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> The CCAA was enacted in 1933 and was necessary – as the then Secretary of State noted in introducing the Bill on First Reading – "because of the prevailing commercial and industrial depression" and the need to alleviate the effects of business bankruptcies in that context. One of the greatest effects of that Depression was what Gibbs J.A. described as "the social evil of devastating levels of unemployment". Since then, courts have recognized that the Act has a broader dimension than simply the direct relations between the debtor company and its creditors and that this broader public dimension must be weighed in the balance together with the interests of those most directly affected: see for example, *Elan Corp. v. Comiskey (Trustee of)*, *per* Doherty J.A. in dissent; *Re Skydome Corp.*; *Re Anvil Range Mining Corp.*
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> In this respect, I agree with the following statement of Doherty J.A. in *Elan*, *supra*:
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>> . . . [T]he Act was designed to serve a "broad constituency of investors, creditors and employees". Because of that "broad constituency" the court must, when considering applications brought under the Act, *have regard not only to the individuals and organizations directly affected by the application, but also to the wider public interest.*[14]

No discussion of stakeholders would be complete without addressing creditors. A *CCAA* restructuring lives or dies based on creditor support. Canadian insolvency professionals point with some pride to the fact that restructuring proceedings under the *CCAA* are generally faster and much less expensive than comparable proceedings in the United States under Chapter 11 of the *Bankruptcy Code*. One logical question that arises is why do American businesses continue to utilize a process that, to Canadians at least, appears to be vastly more cumbersome and relatively more expensive than other options? The answer, anecdotally and from ongoing experience, is that the outcome of restructuring proceedings that are led by businesspeople rather than a receiver or court officer are preferred by stakeholders despite the costs and delay. Indeed, one recent empirical study from the United States concluded that "creditors and shareholders can more than double their recoveries by reorganizing large public companies instead of selling

[14] *Metcalfe & Mansfield*, *supra*, note 8 at paras. 50-52 (citations and endnotes omitted; emphasis in the original).

them."[15] Keeping the debtor at the helm seems to produce more satisfactory results for creditors, and indeed all relevant stakeholder groups.

What should be obvious from this very cursory introduction is that many interests are at stake during a restructuring, all of which should be well understood by the board of directors charged with marshalling the process. Even when a company is solvent, the board of directors must be cognisant of the interests of the company's stakeholders as the board fulfills its statutory obligation to act in the best interests of the corporation.[16] As the Supreme Court of Canada found in *Peoples Department Stores Inc. (Trustee of) v. Wise* ("*Peoples*"), when a corporation approaches the "vicinity of insolvency" the directors continue to owe fiduciary duties to the company, including a consideration of the interests of the various stakeholders.[17] The content of this fiduciary duty can change between normal operation and the vicinity of insolvency, and can change again once the company enters a restructuring under the *CCAA*. So although the duties that are owed by a board can change if a company becomes insolvent, the practice of having to be aware of and potentially accountable for various interests does not change. As such, there is no automatic reason why the same board which served a company when it was solvent, cannot similarly do so during the restructuring process. Indeed, one can make the argument that a board of directors, through the experience of serving the company in times of solvency, should be best placed to serve it in times of insolvency too.

Some have noted that restructurings under the *CCAA* have unclear theoretical justifications (beyond the pragmatic) and that consequently it is difficult to identify appropriate objectives for directors and their debtors to achieve during the restructuring process.[18] However, even without a defined theoretical basis for choosing restructuring objectives, courts and Parliament have created and fostered incentives, such as the directors' charge, to encourage the

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[15] Lynn M. LoPucki & Joseph W. Doherty, "Bankruptcy Fire Sales" (2007-2008) 106 Mich. L. Rev. 1 at 4. The authors found that sales received 35% of book value, but reorganizations yielded an average fresh-start value of 80% of book value.

[16] *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68, [2004] 3 S.C.R. 461 at para. 42. This is in reference to fulfilling the fiduciary duty under s. 122(1)(a) of the *CBCA*, *supra*, note 6.

[17] *Ibid.* at paras. 46-47.

[18] Andrew J.F. Kent *et al.* "Canadian Business Restructuring Law: When Should a Court say "No"?" (2008) 24 B.F.L.R. 1 at 4-5.

incumbent directors to be the group that leads the efforts to meet those objectives. Indeed, Justice Farley's statement of the purpose of the *CCAA* in *Lehndorff General Partner Ltd., Re* ("*Lehndorff*"), simply cannot be fulfilled without an attentive and informed board:

> The CCAA is intended to facilitate compromises and arrangements between companies and their creditors as an alternative to bankruptcy and, as such, is remedial legislation entitled to a liberal interpretation. It seems to me that the purpose of the statute is to enable insolvent companies to carry on business in the ordinary course or otherwise deal with their assets so as to enable [sic] plan of compromise or arrangement to be prepared, filed and considered by their creditors and the court. In the interim, a judge has great discretion under the CCAA to make [sic] order so as to effectively maintain the status quo in respect of an insolvent company while it attempts to gain the approval of its creditors for the proposed compromise or arrangement which will be to the benefit of both the company and its creditors. […] One of the purposes of the CCAA is to facilitate ongoing operations of a business where its assets have a greater value as part of an integrated system than individually. The CCAA facilitates reorganization of a company where the alternative, sale of the property piecemeal, is likely to yield far less satisfaction to the creditors.[19]

Litigation that arose from the restructuring of Stelco Inc. offers an important insight into the respective roles of directors and the courts during a *CCAA* restructuring.[20] In that case, the principals of two investment management firms that had accumulated shares in Stelco requested to be appointed to Stelco's board of directors. The board appointed them on the basis that the two principals could positively contribute to Stelco's restructuring and ongoing operations.[21] Several days after the appointments, the supervising *CCAA* judge removed the new appointees from the board at the behest of certain creditors.[22] The judge justified this removal not based on actual conduct, but partially on fears that these directors might not act neutrally as among the stakeholders due to their ties to significant shareholders. He held that "the fallout would be very detrimental to Stelco and its ability to successfully emerge."[23] In *Stelco Inc., Re* ("*Stelco*"), the Court of Appeal overturned the decision after examining the respective roles of the company and the court in a *CCAA* proceeding, all in light of the court's broad discretion to supervise the restructuring under section 11 of the *CCAA*:

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[19] *Lehndorff General Partner Ltd., Re* (1993), 17 C.B.R. (3d) 24 at paras. 5 and 7 (Ont. Gen. Div.) (WeC).

[20] *Stelco Inc., Re* (2005), 75 O.R. (3d) 5 (C.A.), rev'g (2005) 7 C.B.R. (5th) 310 (Ont. S.C.J. (C.L.)).

[21] *Stelco Inc.* (C.A.), *ibid.* at para. 21.

[22] *Stelco Inc.* (S.C.J.), *supra* note 20.

[23] *Ibid*. at para. 23.

> What the court does under s. 11 is to establish the boundaries of the playing field and act as a referee in the process. The company's role in the restructuring, and that of its stakeholders, is to work out a plan or compromise that a sufficient percentage of creditors will accept and the court will approve and sanction. The corporate activities that take place in the course of the workout are governed by the legislation and legal principles that normally apply to such activities. […] But the s. 11 discretion is not open-ended and unfettered. Its exercise must be guided by the scheme and object of the Act and by the legal principles that govern corporate law issues. Moreover, the court is not entitled to usurp the role of the directors and management in conducting what are in substance *the company's* restructuring efforts.[24]

The discussion in *Stelco* about the basis of a court's jurisdiction is very relevant to the later discussion of a court's jurisdiction and discretion to grant a directors' charge. In *Stelco* the Court of Appeal specifically addressed the source of a court's jurisdiction to remove directors, and disagreed with the finding of the motion's judge that such a power was founded on inherent jurisdiction.[25] Instead, the Court of Appeal found that any such power would have to be rooted in a court's discretion under section 11 of the *CCAA*, with certain limits as quoted above on the exercise of this power.[26]

Stelco highlights the court's important, but limited, role in restructuring an insolvent company. More importantly, it demonstrates that fulfilling the goal of the *CCAA* to facilitate restructurings[27] inexorably recognizes the primacy of the company in a debtor-centric restructuring process. A more difficult question arises however, in considering the nature of the duties owed by directors in a restructuring particularly given the lack of clarity as to the overall objectives referred to above.

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[24] *Stelco Inc.* (C.A.), *supra* note 20 at para. 43 (emphasis in the original). It is recognized that an amendment to the *CCAA* under proposed section 11.5(1) would effectively overrule the Court of Appeal's decision. Proposed section 11.5(1) would provide authority for a court to remove a director who is or "is likely to unreasonably impair the possibility of a viable compromise or arrangement." While this amendment, if proclaimed, would overrule the substance of the decision, the general principle as to the central role of the company in leading the restructuring remains: Bill C-55, *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, 1st Sess., 38th Parl. 2005, cl. 128. See Marie Bruchet, "Director Removal under the CCAA" (2008) 24 B.F.L.R. 269.

[25] *Stelco Inc.* (C.A.), *supra*, note 20 at paras. 34-38.

[26] *Ibid.* at paras. 39-51.

[27] As recently affirmed by the Ontario Court of Appeal in *Metcalfe & Mansfield*, *supra*, note 8 at para. 50.

3) To whom do directors owe a duty during a restructuring?

There is an important relationship between shareholders and directors, the logic of which breaks down in a restructuring. The result is that during a restructuring a difficult question presents itself: to whom do directors owe their fiduciary duty and duty of care? Indeed, Andrew Kent *et al.* recently suggested that the thrust of *Stelco* and *Peoples* leave a vacuum, as they "[do] not inform the directors about how and why the extraordinary powers of a debtor in a reorganization are to be addressed."[28] It is a truism that the board's role in a restructuring is to "ensure that it always has sufficient reasonable basis for believing that the decisions it is making will enhance, or at the very least, maintain overall enterprise value while not unfairly or unduly prejudicing any other stakeholder interest."[29] Precisely how the directors balance those interest is not so obvious.

In the normal course, the shareholders "own" the corporation. In the absence of a unanimous shareholders' agreement, however, it is the directors as elected by the shareholders and not the shareholders themselves, who are responsible for managing the corporation.[30] With respect to the statutory duties that directors owe, the phrase "best interests of the corporation" does not simply concern the best interests of shareholders, but concerns maximizing the value of the corporation.[31] Maximizing value requires a board of directors to consider the interests of a wide group of stakeholders including shareholders, employees, suppliers, creditors, consumers, governments and the environment.

In the context of a *CCAA* restructuring, however, the courts have been clear with respect to the position of shareholders. As the Supreme Court in *Peoples* stated:

> The interests of shareholders, those of the creditors and those of the corporation may and will be consistent with each other if the corporation is profitable and well capitalized and has strong prospects. However, this can change if the corporation starts to struggle financially. The residual rights of the shareholders will generally become worthless if a corporation is declared bankrupt.[32]

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[28] Kent, *supra*, note 18 at 11.

[29] Schwill, *supra*, note 9 at 159.

[30] *Peoples*, *supra*, note 16 at para. 31.

[31] *Ibid.* at para. 42.

[32] *Ibid.* at para. 44.

In an insolvency, where the corporation's liabilities exceed its assets by definition, there may often be no value remaining for the shareholders. For example, in *Canadian Airlines Corp., Re* ("*Canadian Airlines*"), the Alberta Court of Queen's Bench recognized that when a corporation is insolvent, the shareholders would get nothing upon liquidation.[33] In such circumstances, it is not unfair or unreasonable for the creditors or the court to affect changes without any approval of the shareholders, because shareholders can properly be at the "bottom of the hierarchy of interests in liquidation or liquidation related scenarios."[34] *Loewen Group Inc.* ("*Loewen*") stands for a similar proposition.[35]

Note the conflict between the decisions in *Peoples* and in *Canadian Airlines*. The Supreme Court of Canada in *Peoples* found that the best interests of the corporation include taking account of the interests of shareholders.[36] However, in *Canadian Airlines* and in *Loewen*, the courts found that those shareholders no longer had an economic interest to protect in the corporation. The question thus becomes ,when weighing the different interests as required by *Peoples*, how does one strike the correct balance?

The difficulty of such balancing is especially evident with respect to the board of directors acting as the administrator of a pension plan during a restructuring. In Ontario, the company, and thus its board of directors, is almost always the administrator of the pension plan.[37] Acting as the administrator imports fiduciary duties that the company and its board of directors owe to the plan members. These duties require that directors not act in a self-interested fashion.[38] When the board of directors is the pension plan administrator during a restructuring,

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[33] *Canadian Airlines Corp., Re* (2000), 265 A.R. 201 at paras. 74-79 (Alta. Q.B.).

[34] *Ibid.* at para. 77. Farley J. made similar comments in *T. Eaton Co., Re* (1999), 15 C.B.R. (4th) 311 at para. 9 (Ont. S.C.J.(C.L.).

[35] Farley J. in *Loewen Group Inc.* (2001), 32 C.B.R. (4th) 54 at para. 8 (Ont. S.C.J.) found that where the shareholders in a restructuring have no economic interest to protect, they should not have a right to veto a plan of arrangement.

[36] *Peoples*, *supra*, note 16 at paras. 46-47.

[37] *Pension Benefits Act*, R.S.O. 1990, c. P-8, s. 8(1)(a).

[38] Eileen E. Gillese, "The Fiduciary Liability of the Employer as Pension Plan Administrator" (1996) *Pension and Other Benefit Funds: Who is a Fiduciary?* Toronto, Ontario: 18 November 1996. The Canadian Institute. 1-25 at 7.

how does it fulfill its duty to plan members while also fulfilling its duties to the other stakeholders?

Consider a hypothetical example where a board of a company, that is also the pension plan administrator, is in a restructuring and has a limited amount of money. If the pension arrears are outstanding, then the board has a statutory fiduciary duty to fund them. The proper course for the board becomes very murky indeed should a DIP lender insist that money can only be used for payments for ongoing goods and services. One can imagine any number of conflicting duties that could arise when a board of directors must act in the best interests of the pension plan members while also seeking to act in the best interests of all the other stakeholders.

The Ontario Court of Appeal recently confronted the problem of conflicting duties in a restructuring and bankruptcy in *Slater Steel Inc (Re)* ("*Slater Steel*").[39] In that case, the debtor's former directors argued that, although they served on a committee that was the pension plan administrator, they did so in their capacity as directors. Consequently, they believed that claims against them for breaching their duties as plan administrator were barred by a release in a *CCAA* order that prevented claims against directors. The Court of Appeal resolved these issues of conflicting duties by finding as follows:

> Recognizing the different roles that the Slater Personnel fulfilled while on the Audit Committee makes sense of the inherent conflict of interest that otherwise existed for them. Here is one example of the conflict of interest that would exist if these different roles are conflated. The Audit Committee had to decide how much money Slater would contribute to the Plans annually. If the Slater Personnel, in the guise of the Audit Committee, made that decision in their capacity as directors or officers of Slater, they did so while owing a duty to Slater. Given the financial difficulties that Slater faced, that duty would have led them to minimize the amount that Slater contributed to the Plans.
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> However, when the Audit Committee made decisions on the quantum of Slater's contribution to the Plans, it did so in order to fulfill Slater's obligations as administrator of the Plans. An administrator owes a fiduciary duty to the members of the Plans. The Audit Committee "stood in the shoes" of Slater *qua* administrator when making the decision; therefore, it too owed a fiduciary duty to the Plans' members. Fulfillment of that duty would have led to maximizing the contributions that Slater would make to the Plans as that would best protect the Plans members' pensions. In light of Slater's precarious financial position -- a fact that was known or ought to have been known by the Slater Personnel -- this duty was heightened because the need for solvency funding should have been apparent.
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> If the Slater Personnel are treated solely as directors and officers, they were in an impossible position. They could not fulfill their duties both to Slater and to the Plans' members. That impossibility is obviated if the roles played by the Slater Personnel are kept separate. Viewed in

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[39] *Slater Steel Inc (Re)*, 2008 ONCA 196, leave to appeal refused 2008 CarswellOnt 5185 (S.C.C.) (WeC) (sub non. *Morneau Sobeco Ltd. Partnership v. Aon Consulting Inc.*).

> this way, although the Slater Personnel were appointed to the Audit Committee by virtue of their positions as directors and officers, when making decisions in respect of the Plans' administration they did so as agents and employees of Slater *qua* administrator -- not as directors and officers.[40]

The situation for directors who owe duties to both pension plan members and the company is troubling, especially given this ruling in *Slater Steel* that the different roles of the same individuals can give rise to different duties. These duties are often irreconcilable.

Unfortunately, under Ontario's *Pension Benefits Act*, the regulator has limited ability to prevent these conflicting duties as it can only wind-up pension plans in limited circumstances.[41] The board members *qua* administrator are therefore left in an unenviable position from which they may have no choice but to seek to resign.[42] Upon a restructuring, it might be optimal if board members resign from the discrete role as the pension plan administrator at the outset as the risk of conflict of interest is patent. It does not follow, however, that all directors should resign from the board in every restructuring. On the contrary, directors can play a crucial role in restructurings, but the existence of unclear objectives and the potential for latent conflicting duties demonstrates the ongoing risks of acting as a director that support the need for protections in order to keep directors in place.

4) Statutory liability of directors

In addition to uncertainties as to the objectives and duties of directors, numerous statutes impose liability personally on directors should the company fail to comply with statutory obligations. The risk of such failures and therefore the risk of statutory liability are considerably heightened when a company approaches the vicinity of insolvency. Worse still, unlike breaches of fiduciary duties discussed above, statutory liabilities are often incurred without personal fault

[40] *Ibid.* at paras. 33-35.

[41] *Pension Benefits Act*, *supra*, note 37 s. 69. The question of whether the Superintendent can be prevented from acting because of a stay under section 11 of the *CCAA* is another issue entirely.

[42] *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.* (1993), 15 O.R. (3d) 730 at paras. 138-40 (C.A.), leave to appeal refused (1993), 16 O.R. (3d) xvi (note) (S.C.C.).

or wrongdoing and can be incurred simply because a person is a director.[43] While information on the various types of personal liability facing directors can be found in the footnote to the preceding sentence, two examples of this liability will suffice to demonstrate its breadth. First, under the *Income Tax Act* directors of a corporation are liable for a failure to remit or pay certain corporate taxes.[44] The danger for directors is that when insolvency approaches a company may choose, or be pressured to choose, to utilize scarce funds to pay creditors whose goods and services can keep the company in operation, rather than to pay taxes that are due then or in the future.[45] Second, under section 119 of the *Canada Business Corporations Act* (the "*CBCA*"), directors are personally liable to employees "for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively."[46]

In addition to statutory liability, when creditors and other stakeholders are faced with a situation where they will suffer losses because of a company's insolvency, they often target directors as either an alternative source of recovery or as parties to be pressured in order to drive a desired outcome. In the face of such liability and pressure, directors are often faced with difficult decisions. Numerous articles discuss the reality that directors consider resigning from the board in order to attempt to avoid liability.[47] One might reasonably question why directors should remain willing to serve when faced with foreseeable liabilities in view of the insolvency

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[43] Numerous articles detail the personal liability that directors face: Lazar Sarna, *Directors and Officers: A Canadian Legal Manual*, looseleaf (Markham: LexisNexis, 2005), contains an entire chapter on the personal civil liability of officers and directors; Baird & Davis, *supra*, note 13 at 96-99 contains an appendix entitled "Liability of Directors for Employee Claims"; Geoffrey B. Morawetz, "Under Pressure: Governance of the Financially Distressed Corporation" in Janis P. Sarra, ed. *Corporate Governance in Global Capital Markets* (Vancouver: UBC Press, 2003) 275 at 283-86; Carol Hansell, *What Directors Need to Know: Corporate Governance* (Toronto: Carswell, 2003) at 137-154 contains an entire chapter entitled "Liability Issues"; Christopher W. Besant & E. Patrick Shea "Report of the Directors' Liability Committee: Directors' Liability and the Insolvent Business Corporation" (Report presented to the Eighth Annual General Meeting and Conference of the Insolvency Institute of Canada, Toronto, Ontario, September 25-28, 1997) I.I.C. Art. 1997-2 (WeC).

[44] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 227.1.

[45] Morawetz, *supra*, note 43 at 285.

[46] *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 s. 119.

[47] Schwill, *supra*, note 9 at 167; M. Christopher Diamond, "Representing Directors and Officers: Spotting the Issues and Knowing Your Limits" (2006) 24 Can. J. Ins. L. 53 at 60; Morawetz, *supra*, note 43 at 287; Jacob S. Ziegel, "The Modernization of Canada's Bankruptcy Law in a Comparative Context" (1999), 4 C.B.R. (4th) 151 at 163.

of the corporation. Some suggest that it is in the best interests of the directors to stay on during the restructuring, given that they will be viewed as part of the solution and thus will be less likely targeted by potential lawsuits. As recently expressed by American commentators:

> Notwithstanding these potential distractions, each member of the board and management must separate him- or herself from personal issues and frequently may be best off by retaining his or her position with the company until the restructuring is complete. By staying with the company, board members and managers have the opportunity to be, and to be perceived as being, part of the restructuring solution. If they leave the company, however, creditors are likely to remember them as having been part of the problem, which does not bode well for their affirmative treatment under a reorganization plan, including the prospect of obtaining any sort of release, indemnification, or exculpation.[48]

Others note that board members do not generally resign, even when the corporation that they serve is faced with insolvency. The justification is that "[i]t is generally not in the make-up of those who seek to govern corporate activities to readily remove themselves from the fight to restore a company."[49] Geoffrey Morawetz has argued, before his appointment to the bench, that it is the pre-filing stage of insolvency that poses the greatest risks for directors, and it could follow that resignations would happen at that time.[50] In the pre-filing stage, decisions are made without any court approval thus leading to closer scrutiny by corporate stakeholders at a time when the protections offered to directors in a *CCAA* restructuring are not yet available.

It is clear that many directors do resign from the boards of companies that are approaching the vicinity of insolvency to protect themselves from personal liability. It is undeniable that resignation may prevent directors from incurring future liabilities. For example, under section 119 of the *CBCA*, directors are only liable for wages that accrued during their tenures.[51] The public policy goals of the section 119 liability are obvious, as the statute requires directors to ensure that the interests of employees are protected. However, the statute might also encourage a director to resign at the earliest signs that insolvency is looming.

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[48] D.J. Baker *et al.*, "Corporate Governance of Troubled Companies and the Role of Restructuring Counsel" (2008) 63 *The Business Lawyer* 855 at 861.

[49] William E. Aziz *et al.*, "Practical Aspects of Governing Distressed Enterprises in Canada" in Janis P. Sarra, ed. *Annual Review of Insolvency Law: 2006* (Toronto: Thomson Carswell, 2007) 365 at 400.

[50] Morawetz, *supra*, note 43 at 275.

[51] *Brown v. Shearer*, [1995] 6 W.W.R. 68 (Man. C.A.).

Indeed, before the *CBCA* was amended to allow a due diligence defence for directors, William Dimma, in his comments to the Senate Committee on Banking, Trade and Commerce, described the potential personal liability faced by directors in the following terms:

> More typical is the situation where honest, hard-working directors, doing everything in their power to keep the ship afloat, face an inevitable drift towards corporate insolvency. They are confronted, quite unfairly, with onerous personal liabilities and even, on occasion, with personal bankruptcy. Any law which forces directors to resign at the very moment when they are needed most is dysfunctional in the extreme.[52]

When directors resign, there is an increased risk that a viable but financially troubled business will not be able to successfully restructure.[53] This suggests that to accept the premise that stakeholders prefer a debtor-led proceeding and the *CCAA* gives primacy to the debtor in such proceedings, then directors must be provided with certain protections from liability to prevent them from resigning.

5) Statutory protections for directors

As discussed, numerous statutes impose liability on directors. These provisions exist to advance certain laudable goals, such as requiring directors to be responsible for vulnerable stakeholders such as employees.[54] The downside, as has long been recognized, is that potential liability might cause directors to resign in order to forestall this liability against them.[55] There are however two important protections for directors that are authorized by statute, namely the allowances for indemnification and insurance under section 124 of the *CBCA*.[56]

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[52] William A. Dimma, *Excellence in the Boardroom: Best Practices in Corporate Directorship* (Etobicoke: Wiley, 2002) at 196-97. In response to such criticisms, amendments to the *CBCA* came into force in 2001 to allow a due diligence defence for directors: see *CBCA*, *supra*, note 46 s. 123(4).

[53] McElcheran, *supra*, note 8 at 225.

[54] Given that it is the government that is enacting the legislation, it is also unsurprising that directors are held liable for unremitted tax deductions as such liability will encourage the directors to ensure the government gets its due. But to be fair, it is in the public's interest to have the government collect taxes, given that it is the public that benefits from these taxes through public services.

[55] See footnotes 47, *supra*.

[56] Although reference is only given to the *CBCA* in this article, other provincial corporate statutes also authorize indemnities and insurance for directors. See, for example, section 136 of the Ontario *Business Corporations Act*, R.S.O. 1990, c. B-16.

Typically, companies are permitted, but not required, to indemnify directors, both past and present, against costs and expenses including amounts to settle lawsuits that arise due to their association with the corporation.[57] A mandatory right of indemnification also exists for costs associated with the successful defence of lawsuits, so long as the director fulfilled his or her fiduciary duty to the company.[58] Though these rights seem quite broad, there are potentially troubling limits to the protection they can offer. Any indemnification agreement with a company, or indeed a statutory right to indemnification, offers little protection to a director if the company has no funds to honour the indemnity. Liabilities arising during a restructuring that leave a director with an unsecured claim against the company are small comfort.

As well, a recent decision from the Delaware Court of Chancery would be a troubling development for directors if applied in Canada.[59] In *Schoon v. Troy Corp.*, a company amended its by-laws for the express purpose of removing indemnification protection for former directors.[60] A former director, who was protected under the by-laws when he resigned, subsequently sought to enforce the protections in the old by-laws by arguing that his protection vested when he took office and could not be subsequently modified without his consent.[61] The court upheld the disentitlement and affirmed the right of the company to amend its by-laws, as long as the former board member was not named in a lawsuit when the by-laws were changed. In other words, so long as a board member's specific indemnification right had not vested by virtue of a lawsuit, the right could be removed. Thus, an important lesson for directors is to ensure that, in addition to statutory and by-law indemnification, they should also require a contractual indemnity, which would prevent unilateral action to remove any permissive indemnification rights. However, even contractual indemnities lose much of their value where the indemnifier is itself insolvent.

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[57] *CBCA*, *supra*, note 46 s. 124(1).

[58] *Ibid.* s. 124(3).

[59] Sandra Rubin "U.S. case 'a wake-up call for Canadian directors'" *The Globe and Mail* (6 August 2008) B5.

[60] *Schoon v. Troy Corp.*, 948 A.2d 1157 at 1165 (Del. Ch. 2008). The specific right at issue was advancement for expenses incurred in the course of a lawsuit.

[61] *Ibid.* at 1166.

In addition to providing indemnities, companies are also permitted to maintain insurance for individuals in their capacity as directors of the corporation.[62] Insurance and indemnification are complementary forms of protection for directors, especially during a restructuring. The *CCAA*, as currently in force, is silent on indemnification and insurance, although amendments are proposed that may disrupt the ability of insurance and indemnification to complement one another.

In addition to the statutorily-authorized protections afforded to directors by insurance and indemnification, a third form of protection exists that is only available in a restructuring: the directors' charge.

6) The directors' charge

The directors' charge, being a court ordered super-priority security interest against the debtor's assets, can be created in a *CCAA* initial order and is an important tool that can protect directors from the liabilities they may face. At the outset of a restructuring, the directors' charge is especially important in encouraging directors to remain in their positions because the value of indemnities and insurance to directors is significantly weakened by that point.

As for insurance, its availability is often too uncertain at the outset of an insolvency to be a decisive factor to keep directors from resigning. Despite the existence of insurance at the beginning of a restructuring, there is no guarantee that it will in fact cover directors if they are sued later. In practical terms, an insurer cannot be expected to readily agree to be bound to insure hypothetical claims before they are brought. Coverage can also always be denied because of pre-contractual misrepresentations that may not be discoverable until a later time. Policies can lapse. In some types of directors' insurance, coverage is shared with the company, whereby a director's claim for indemnity could be drawn from the same policy pool used to pay other claims against the company. Claims from these numerous sources can quickly exhaust the available funds, depending on the number and size of claims. Similarly, common law rules that provide that insurance coverage is to be paid out as claims are resolved sequentially, with no sharing if limits are exhausted, create another substantial uncertainty as to the adequacy of

[62] *CBCA*, *supra*, note 46 s. 124(6).

coverage. Such factors cannot be known before the restructuring process begins. Therefore, at the outset of a restructuring proceeding there is often a risk of a gap in the coverage otherwise provided by indemnities and insurance.

The directors' charge can fill this gap in protection left by indemnities and insurance. A directors' charge in an initial order creates a pool of money that ranks in some priority to other claims in the restructuring. The purpose of the charge, as has been affirmed by the Ontario Court of Appeal, is to keep directors in place during a restructuring.[63] The directors' charge provides additional protection from other liabilities that directors might incur as a consequence of the insolvency, but which cannot be definitively covered by insurance due to the uncertainty of insurance coverage.[64] In this sense, the charge and insurance are complementary as both together can provide the assurance required to keep directors from resigning.

7) The court's jurisdiction to grant a directors' charge

The directors' charge is not authorized by any explicit wording of the *CCAA*. Yet, it has been employed to affect a specific and important goal: to protect directors from liabilities in order to induce them to not resign and thus to help the company during the restructuring process.[65] The practical result provides a preference for directors, which ranks ahead of other interests in the restructuring. As a judicially created charge is clearly an interference with private rights, the jurisdiction for the charge should be understood.

One could argue, as we do, that given the inability of indemnities and insurance to sufficiently protect directors from the liability they face in a restructuring, if one wants to retain the incumbent directors one often must have a directors' charge. The difficulty with this pragmatic justification is that it does not address the court's legal authority to grant a directors' charge in an initial *CCAA* order.

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[63] *General Publishing Co., Re* (2003) 39 C.B.R. (4th) 216 at paras. 6-7 (Ont. S.C.J.), aff'd (2004) 1 C.B.R. (5th) 202 (Ont. C.A.); *Western Express Air Lines Inc., Re* (2006), 21 B.L.R. (4th) 84 at 25 (B.C. S.C.).

[64] *General Publishing*, *ibid.* at para. 6.

[65] Janis Sarra, "Steel, Sulphur and Coal: Update on Debtor in Possession Financing and Priming Liens in CCAA Applications" (Paper presented to the Insolvency Institute of Canada, 13th Annual Conference, Victoria, B.C., September 2002) I.I.C. Art. 2002-4 (WeC).

According to a recent article by Madam Justice Georgina Jackson and Dr. Janis Sarra, inquiring into the legal basis of the directors' charge is important to establish the proper scope and availability of such orders. The thesis is that it is also important to clearly articulate the basis for a court's authority to do certain things – for example, to grant charges – in insolvency matters.[66] Jackson and Sarra argue that an undefined basis for rulings creates uncertainty for parties trying to understand the principles or rationales of judgments, which can lead to future unpredictability or uncertainty in the jurisprudence.[67]

In order to address a court's jurisdiction in insolvency proceedings, Jackson and Sarra proposed a "hierarchy of judicial tools" to guide the search for the elusive jurisdictional basis of insolvency orders. This analysis is focused on situations, not where the legislation is ambiguous, but where the legislation simply does not address what the courts are being asked to decide:

> On the authors' reading of the commercial jurisprudence, the problem most often for the court to resolve is that the legislation in question is under-inclusive. It is not ambiguous. It simply does not address the application that is before the court, or in some cases, grants the court the authority to make any order it thinks fit. While there can be no magic formula to address this recurring situation, and indeed no one answer, it appears to the authors that practitioners have available a number of tools to accomplish the same end. In determining the right tool, it may be best to consider the judicial task as if in a hierarchy of judicial tools that may be deployed. The first is examination of the statute, commencing with consideration of the precise wording, the legislative history, the object and purposes of the Act, perhaps a consideration of Driedger's principle of reading the words of the Act in their entire context, in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament, and a consideration of the gap-filling power, where applicable. It may very well be that this exercise will reveal that a broad interpretation of the legislation confers the authority on the court to grant the application before it. Only after exhausting this statutory interpretive function should the court consider whether it is appropriate to assert an inherent jurisdiction. Hence, inherent jurisdiction continues to be a valuable tool, but not one that is necessary to utilize in most circumstances.[68]

Jackson and Sarra place statutory interpretation at the top of their hierarchy of judicial tools. It is the court's first recourse when ascertaining jurisdiction. This can include the construction of relevant statutory language, if any, the process of "gap-filling", and a consideration of the scope

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[66] Georgina R. Jackson & Janis Sarra, "Selecting the Judicial Tool to get the Job Done: An Examination of Statutory Interpretation, Discretionary Power and Inherent Jurisdiction in Insolvency Matters" in Janis Sarra, ed. *Annual Review of Insolvency Law: 2007* (Toronto: Thomson Carswell, 2008) 41.

[67] *Ibid.* at 45.

[68] *Ibid.* at 94.

of judicial discretion to stay proceedings under section 11 of the *CCAA*. The remaining tool is inherent jurisdiction, which is narrower and which should only be used if a purposive interpretation of the relevant legislation does not provide jurisdiction.[69]

The case law provides multiple justifications for a court's jurisdiction to create charges during a restructuring pursuant to the *CCAA*. Such charges, including the directors' charge, are not explicitly dealt with by the wording of the *CCAA*, and perhaps it is unsurprising that there is uncertainty over the precise legal basis of these charges in theory. Jurisdiction has been found by courts by interpreting the statute, by invoking inherent jurisdiction, and by virtue of the court's equitable jurisdiction.

Court ordered charges against the assets of a company in a *CCAA* proceeding were first given formal recognition in a reported case in the 1992 decision of *Re Westar Mining Ltd.* ("*Westar Mining*") a case concerning a charge to secure credit extended by suppliers.[70] In *Westar Mining* and other *CCAA* cases that followed, the court explicitly justified the charges on the basis of the court's inherent jurisdiction.[71] As recognized by Jackson and Sarra, until recently there had been "a particular willingness at least by trial courts to use inherent jurisdiction to fill gaps in legislation" when dealing with commercial matters, and particularly the "skeletal" *CCAA* legislation.[72] A court's equitable jurisdiction has also been cited as providing jurisdiction for super-priority DIP financing under the *CCAA*.[73] As summarized in an

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[69] *Ibid.* at 42.

[70] *Re Westar Mining Ltd.* (1992), 14 C.B.R. (3d) 88 (B.C. S.C.), as stated in *United Used Auto & Truck Parts Ltd. Re* (1999), 12 C.B.R. (4th) 144 at paras. 22 (B.C. S.C.), aff'd (2000), 16 C.B.R. (4th) 141 (B.C. C.A.), leave to appeal allowed [2000] S.C.C.A. No. 142 (S.C.C.).

[71] *Westar Mining*, *ibid.* at paras. 21-24; *Royal Oak Mines Inc., Re* (1999), 7 C.B.R. (4th) 293 at para. 4 (Ont. S.C.J. (C.L.)): "In light of the very general framework of the CCAA, judges must rely upon inherent jurisdiction to deal with CCAA proceedings. However, inherent jurisdiction is not limitless; if the legislative body has not left a functional gap or vacuum, then inherent jurisdiction should not be brought into play."; *Dylex Ltd., Re* (1995), 31 C.B.R. (3d) 106 at para. 8 (Ont. Gen. Div. (C.L.): "In the interim between the filing and the approval of a plan, the court has the inherent jurisdiction to fill in gaps in legislation so as to give effect to the objects of the CCAA, including the survival program of a debtor until it can present a plan."

[72] Jackson & Sarra, *supra*, note 66 at 78.

[73] *United Used Auto* found that super-priority for DIP financing found its jurisdiction in equity: *United Used Auto* (C.A.), *supra*, note 70 at paras. 30-31. *Re Skeena Cellulose Inc.*, in *obiter*, found that special provisions for paying the fees and expenses of monitors under the *CCAA* would find its jurisdiction in equity and "statutory discretion" under the *CCAA*: *Re Skeena Cellulose Inc.* (2003), 43 C.B.R. (4th) 187 at para. 47 (B.C. C.A.).

article from 2003 concerning charges in restructurings, "[t]he Courts' authority to grant priority charges now seems beyond debate and is founded on the Courts' inherent and equitable jurisdiction."[74]

More recently, courts have identified a statutory basis for charges to which some priority attaches, by interpreting existing provisions of the *CCAA*. In *Sulphur Corp. of Canada Ltd., Re* ("*Sulphur Corp.*"), the Alberta Court of Queen's Bench found jurisdiction to grant a charge under subsections 11(3) and 11(4) of the *CCAA*. Those are the general powers of the court to stay proceedings to allow a restructuring to proceed. The court adopted a broad, purposive and perhaps creative approach to find an implicit legislative sanction to create security interests in a power to stay proceedings. This approach is consistent with the decision of the Ontario Court of Appeal in *Stelco*, in which the court rejected the proposition that courts can broadly act in insolvency matters based on inherent jurisdiction, and instead rooted the court's jurisdiction in a discretion specifically located in the legislation itself.[75]

What *Sulphur Corp.* and *Stelco* perhaps suggest is a shift away from grounding the jurisdiction to grant charges, such as a directors' charge, in the court's inherent jurisdiction, and towards finding it in the interpretation of the *CCAA* statute. The point will perhaps become moot if the amendments to the *CCAA* in Bill C-62 are proclaimed, for as will be discussed, these amendments would create an explicit statutory basis for courts to create a directors' charge.[76]

In the interim, the recognition of a jurisdictional basis to grant charges either as flowing from the court's inherent jurisdiction or from a purposive construction and application of the court's statutory discretion, informs an understanding of the proper scope of the charges consonant with their jurisdictional underpinnings.

8) The proper scope of the directors' charge

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[74] Michael J. MacNaughton & Roger Jaipargas, "Financing a Restructuring (DIP Financing and Priority Charges in CCAA Matters)" (Paper presented to the Canadian Institute Third Annual Insolvency Law & Practice Conference, January 16, 2003), I.I.A. Art. 2003-6 (WeC).

[75] *Stelco Inc.* (C.A.), *supra*, note 20 at paras. 33, 38; see also *Skeena*, *supra*, note 73.

[76] Bill C-62, *supra*, note 7.

As discussed above, the essential purpose of the *CCAA* is to facilitate the successful restructuring of insolvent, viable businesses. To do so, it is desirable to keep incumbent directors from resigning. The judicial directors' charge provides a necessary degree of protection for directors against personal liabilities that are more likely to accrue when the directors' company becomes insolvent. But the charges are preferential and interfere with the negotiated security and property rights of other stakeholders. This suggests that such charges should be limited to ensure that they are tailored to the circumstances so that they facilitate the restructuring effort and do not interfere with the rights of others any more than is necessary to achieve that goal. This also suggests that the traditional flexibility of the *CCAA* should be employed to allow supervision of the scope and quantum of directors' charges.

Whatever one's conclusions on the jurisdictional basis of the directors' charge, it is important to explore the related issues of a court's discretion to grant the directors' charge, as well as its discretion as to the proper scope of the directors' charge. As Dr. Sarra has noted, the benefits to the restructuring process that flow from the directors' charge arise precisely because it is discretionary:

> The charge is under the supervision of the court, which can exercise its discretion to determine whether the charge is appropriate in the circumstances. It reduces the incentives for directors shirking that safe harbours create, because the approach is discretionary, as opposed to automatic. Moreover, the court has the benefit of submissions from creditors before granting such a priority charge.[77]

The malleability of the directors' charge is evident from examining the template *CCAA* initial order used in Ontario, which includes suggested language for the charge. The CCAA Commercial List Users' Committee has created and disseminated a Standard Form Template CCAA Initial Order (the "Ontario Template Initial Order") which includes both an indemnity and a charge for directors (and officers) along with a provision concerning insurance.[78] The Ontario Template Initial Order suggests the following wording as the starting point for all *CCAA* initial orders in Ontario:

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[77] Sarra, *supra*, note 65.

[78] The Ontario Template Initial Order can be found online: Ontario Courts, maintained by the Judges Library, <http://www.ontariocourts.on.ca/scj/en/commerciallist/forms/LF.DOC>. Other provinces have promulgated similar template orders. As all such orders are negotiable in each case, the Ontario version is used for illustration only.

> 21. THIS COURT ORDERS that the Applicant shall indemnify its directors and officers from all claims, costs, charges and expenses relating to the failure of the Applicants, after the date hereof, to make payments of the nature referred to in subparagraphs [6(a)], [8(a)], [8(b)] and [8(c)] of this Order which they sustain or incur by reason of or in relation to their respective capacities as directors and/or officers of the Applicants except to the extent that, with respect to any officer or director, such officer or director has actively participated in the breach of any related fiduciary duties or has been grossly negligent or guilty of wilful misconduct.
>
> 22. THIS COURT ORDERS that the directors and officers of the Applicant shall be entitled to the benefit of and are hereby granted a charge (the "Directors' Charge") on the Property, which charge shall not exceed an aggregate amount of $, as security for the indemnity provided in paragraph [21] of this Order. The Directors' Charge shall have the priority set out in paragraphs [39] and [41] herein.
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> 23. THIS COURT ORDERS that, notwithstanding any language in any applicable insurance policy to the contrary, (a) no insurer shall be entitled to be subrogated to or claim the benefit of the Directors' Charge, and (b) the Applicant's directors and officers shall only be entitled to the benefit of the Directors' Charge to the extent that they do not have coverage under any directors' and officers' insurance policy, or to the extent that such coverage is insufficient to pay amounts indemnified in accordance with paragraph [21] of this Order.[79]

The first thing to note about the Ontario Template Initial Order is that, in practice, the directors' charge in paragraph 22 works to fund the indemnity in paragraph 21. The indemnity, and thus the directors' charge, will not cover a breach of fiduciary duty, gross negligence or wilful misconduct. These limits make sense, as one purpose of the charge is to encourage directors to help the company restructure, but this should not shield the directors from liability that cannot contribute to this purpose. Second, the directors' charge is meant to compliment insurance coverage, such that the charge fills latent gaps in insurance coverage that may become evident at a later date. Third, the Ontario Template Initial Order ranks the directors' charge in third priority, behind only the administration charge and the DIP lender's charge. However, like all provisions of the Ontario Template Initial Order, the quantum and ranking are negotiable in each case, based on the particular facts. The Ontario Template Initial Order assumes that DIP lenders and those benefiting from the administration charge will usually insist that their charges rank ahead of the directors' charge. However, this is not always the case in practice. Finally, the Explanatory Notes that accompanied the release of the Ontario Template Initial Order explicitly state that the charge was intended to retain directors to govern the *CCAA* applicant during the

[79] *Ibid.*

CCAA process.[80] If this goal of retaining the directors is not met, then the charge should perhaps not be allowed or, if it has already been granted, revoked.[81]

As already noted, the *CCAA* does not provide explicit statutory authority for either a directors' charge or indemnification. However, Bill C-62, which has been enacted by Parliament and is awaiting proclamation, proposes amendments to the *CCAA* that would include the following provision relating to directors' charges and indemnification. It will be helpful to set out these proposed amendments here, in order to contrast their treatment of the directors' charge with that of the Ontario Template Initial Order:

> 11.51 (1) On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring that all or part of the property of the company is subject to a security or charge — in an amount that the court considers appropriate — in favour of any director or officer of the company to indemnify the director or officer against obligations and liabilities that they may incur as a director or officer of the company after the commencement of proceedings under this Act.
>
> (2) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.
>
> (3) The court may not make the order if in its opinion the company could obtain adequate indemnification insurance for the director or officer at a reasonable cost.
>
> (4) The court shall make an order declaring that the security or charge does not apply in respect of a specific obligation or liability incurred by a director or officer if in its opinion the obligation or liability was incurred as a result of the director's or officer's gross negligence or wilful misconduct or, in Quebec, the director's or officer's gross or intentional fault.[82]

Though they are not yet law, these proposed amendments attempt to balance the interests of providing directors (and officers) with the security necessary to retain their services, without providing them with a preference. As such, exploring the proposed amendments is a good way to understand issues about the proper scope of directors' charges. Note particularly that the directors' charge under proposed section 11.51(1) could only indemnify obligations incurred

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[80] Commercial List Users' Committee "The New Standard Form Template CCAA First-Day Orders: Explanatory Notes for Long Form and Short Form CCAA Orders" (12 September 2006) at 5, online: Ontario Bar Association <www.oba.org/en/pdf_newsletter/Explanatory.pdf>.

[81] For example, Sellers *et al.* report that in the insolvency and bankruptcy of the airline Canada 3000, "the directors and officers were granted a charge in the Initial Order, but once the airline ceased operation, the directors' and officers' charge was retracted and an order was granted removing the charge *nunc pro tunc*: Edward A. Sellers *et al.*, "Governance of the Financially Distressed Corporation in Global Capital Markets: Selected Aspects of the Financing and Governance of Canadian Enterprises in Cross-Border Workouts" in Janis P. Sarra, ed. *Corporate Governance in Global Capital Markets* (Vancouver: UBC Press, 2003) 297 at footnote 185.

[82] Bill C-62, *supra*, note 7.

after the commencement of *CCAA* proceedings.[83] As well, section 11.51(3) requires that insolvent corporations turn to insurance as the primary protection for directors, with the directors' charge only filling gaps in that insurance.

The Ontario Template Initial Order explicitly limits the indemnity and charge to claims made after the date of the initial order. Such a limitation is eminently sensible, as a directors' charge to facilitate a restructuring that ranks in priority to other claims should not automatically cover pre-*CCAA* liabilities. As stated, the purpose of the judicial directors' charge is to encourage directors to remain in their posts during the *CCAA* restructuring period, in order to increase the likelihood of a successful restructuring. The charge is not provided to whitewash prior wrongful acts or to simply reduce personal exposure.[84] If the directors of an insolvent corporation are only willing to remain as directors during the restructuring if all past liabilities are indemnified, then there is a serious risk of creating a preference for the interests of directors over those of other corporate stakeholders. A practice of broadly indemnifying directors for all pre-*CCAA* liability robs the statutes that created the liabilities of the purposes for which they were enacted. Stated differently, if the purpose of statutory liability for directors is to require them to pay special attention to certain interests that society deems important, then absolving directors of such liability in a restructuring risks removing the incentive of directors to follow those laws in the first place.

Some orders have granted charges that have extended to pre-*CCAA* liabilities. The jurisprudence is quite clear that the issue of whether a directors' charge can cover pre-*CCAA* liabilities turns on the language used in the particular directors' charge. Thus in the 2006 case of *Western Express Air Lines Inc., Re*, the British Columbia Supreme Court found that the directors' indemnity was not limited solely to liabilities going forward.[85] Conversely, in the 2004 case of *Royal Bank of Canada v. KPMG Inc.*, the Saskatchewan Court of Queen's Bench found that the wording of a directors' charge only covered the period after the *CCAA* order.[86] As

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[83] *Ibid.* This provision would also allow charges for officers, while section 5.1(1) of the *CCAA* benefits directors alone, by allowing the compromise of all claims arising before the *CCAA* restructuring: *CCAA*, *supra*, note 6.

[84] Sellers, *supra*, note 81 at 328.

[85] *Western Express*, *supra*, note 63 at para. 30.

[86] *Royal Bank of Canada v. KPMG Inc.*, [2004] G.S.T.C. 76 at paras. 12-13 (Sask. Q.B.).

previously stated, the proposed amendments in Bill C-62 would prevent a directors' charge from covering pre-*CCAA* liabilities. Farley J.'s decision in *Air Canada, Re* ("*Air Canada*") provides an excellent illustration of the difficulty with this categorical position.[87]

Air Canada concerned a directors' charge limited to $170 million that was to cover pre-filing obligations. Counsel for the board of directors argued that the charge was necessary to allow the directors to focus on a successful restructuring and not worry about "being crushed by overwhelming liabilities."[88] Although Farley J. recognized that the potential liabilities faced by the board were potentially crushing to the directors personally, he found it was not appropriate to give the directors a "free pass" with respect to accessing the directors' charge.[89] Farley J.'s solution was as follows: since the directors' charge was to cover "excess" liability not covered by insurance or by existing trusts that had been settled to ensure payment of certain liabilities, he ordered that the officers and directors would be liable for five percent of any amount used from the directors' charge.[90] As Farley J. held: "This exposure will assist in focussing the minds of [the officers and directors] to dedicate themselves to coming up with a successful restructuring plan which would tend to eliminate liability."[91] Thus, the court clearly found that directors should not receive blanket protection during a restructuring from pre-restructuring liabilities they incurred. Still, the court left the door open to allowing a charge to cover some pre-*CCAA* liabilities where doing so would encourage the directors to remain in place.

The cases concerning directors' charges disclose a few indications of their permitted and desirable scope. *General Publishing Co., Re* ("*General Publishing*") was a case concerning a challenge by an insurance company to the language of a directors' charge in a *CCAA* initial order.[92] In that case, an insurer had provided an insurance policy to cover directors' liability and

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[87] *Air Canada*, *supra*, note 9.

[88] *Ibid.* at para. 14.

[89] *Ibid.*

[90] *Ibid.* at para. 17.

[91] *Ibid.*

[92] *General Publishing*, *supra*, note 63.

the policy was extended during the period of the *CCAA* proceeding.[93] The insurance company wished to modify the wording of the directors' charge so that if, in the future, the insurer were to pay a claim under the insurance policy, it could claim through subrogation against the directors' charge. In reasons upheld by the Ontario Court of Appeal, Ground J. dismissed the insurer's motion. He found that the purpose of the directors' charge was to provide additional protection to directors so they maintained their position during the restructuring.[94] This goal would not be enhanced by providing a benefit to the insurer. The Court could see no policy justification for enhancing the priority of the insurer's subrogation rights ahead of other unsecured creditors. As such, any claim that would be covered by the insurance policy should not be an allowable claim against the directors' charge.[95] Thus, insurance and the directors' charge are complementary, not overlapping. The insurance protects directors from covered liabilities; the charge is an adjunct for the purpose of encouraging directors to retain their positions during a restructuring. More generally, Ground J. also agreed that judicial charges should be tailored to minimize interference with other stakeholders' rights:

> In any event, it seems to me that the court, in a CCAA proceeding, should interfere with existing priority rights only to the extent necessary in order for the CCAA proceedings to continue and to provide the company with an opportunity to work out a restructuring or arrangement.[96]

In the result, the insurer was not provided with a super-priority right against the directors' charge for amounts the insurer would have to pay out under the directors' liability policy. The justification, as quoted above, was that this benefit to insurers was not necessary in order to facilitate the company's restructuring. As identified by Farley J. in *Lehndorff*, the purpose of the *CCAA* is to permit a potential benefit for both the company and creditors.[97] As more recently stated by the Ontario Court of Appeal in *Metcalfe & Mansfield Alternative Investments II Corp.,*

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[93] *Ibid.* at paras. 2 and 6.

[94] *Ibid.* at para. 6.

[95] *Ibid.*: "If the claims made against the directors are claims which would have been covered by the Directors' Liability Policy in any event, they should not be claims which could be made against the Directors' Charge Fund in that the fund was put in place to give the directors further protection, over and above the protection accorded by the Directors' Liability Policy, as a result of the increased exposure of the directors due to the company's insolvency."

[96] *Ibid.* at para. 8. The Court of Appeal upheld this reasoning.

[97] *Lehndorff*, *supra*, note 19 at paras. 5 and 7.

(Re), there is also the public interest at stake in *CCAA* restructurings.[98] All of these interests must be considered – the company, its creditors and stakeholders, as well as the broader public interest – when courts decide whether to interfere with existing priority rights. Arguably, allowing directors' charges and thus helping to prevent directors from resigning, brings not only benefits to the company; directors' charges also benefit stakeholders such as creditors, employees and the public interest by facilitating successful restructurings. But as noted in *General Publishing*, the purpose of the charge is also a limiting factor in that it is only necessary to the extent that is will help prevent directors from resigning due to the risk of uncertainty of personal liability.

9) Practical aspects of the directors' charges

Prior to a *CCAA* restructuring and before a company enters the vicinity of insolvency, directors should be expected to fulfill their duties as required by law with no suggestion that they can look to manoeuvre the company into a future *CCAA* proceeding as a form of self-dealing to absolve them of liability. Proper insurance should be in place to cover any potential liability that a director may face, and directors should have indemnity provisions in the corporate by-laws along with separate contracts with the company so that the indemnities will cover them after they have left the board for liability they incurred as a director. Ideally, corporations would have funded statutory obligations by appropriately segregated trusts or accounts as part of directors' ongoing due diligence mechanisms. But the ideal is rarely the case in practice.

If a corporation becomes insolvent, in most cases it is important for directors to remain on the board during this time to increase the possibility of a successful restructuring. However, there is a risk that the mere creation of a broad directors' charge with a priority claim to a large amount of money, while seeming to provide protection to directors, in fact is a form of self-dealing by directors to cover prior wrongful acts. In any event, an unbridled charge just provides a large target for any stakeholder who will not be made whole as a result of the restructuring.[99]

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[98] *Metcalfe & Mansfield*, *supra*, note 8 at paras. 50-52.

[99] As may be alleged to be the case in *Slater Steel*, *supra*, note 39.

Given that a restructuring, by definition, only concerns companies that cannot meet all of their liabilities, there will be such stakeholders.

A broad directors' charge is therefore not advisable, given that it often serves to attract a variety of claimants who are searching to recover lost money. Instead, the directors' charge should be tailored to dovetail with insurance coverage and only fill the gaps and uncertainties in such insurance coverage. The directors' charge should be endowed with enough money to cover identifiable liabilities that the directors will likely face during the restructuring. A directors' charge that only fills gaps in insurance coverage will limit the amount of money to be removed from creditors, the company, and other stakeholders. Such an approach is consistent with the view that a restructuring is meant to benefit the creditors, the company, and the company's various stakeholders and not the directors alone.

Instead, as soon as a company enters the vicinity of insolvency, it is fundamental that proper due diligence be undertaken to determine precisely what potential liabilities exist.[100] Given the nature of the statutory schemes that create liability for directors where the corporation does not fulfill certain obligations, due diligence should also address the precise areas where directors may face liability. It is not enough for directors to accept uncritically the views of management on these issues of liability, given that management might approach the situation from a "business as usual" approach and not from the perspective of a company that faces the real likelihood of insolvency. Too often, management has reported that statutory remittances are "up to date" by which they mean that payments are being made 30, 60 or 90 days in arrears in accordance with existing slow payment practices. The authors cannot stress enough the need for a proper due diligence review prior to undertaking *CCAA* proceedings. Once due diligence is complete, then directors should be in a position, if a *CCAA* restructuring becomes inevitable, to knowledgeably negotiate with creditors and others regarding the proper scope of a directors' charge to cover possible liabilities, particularly statutory liabilities, that may arise in the proposed restructuring, especially if the restructuring were to come to an unexpected or catastrophic end.[101] This should provide sufficient protection so that directors do not resign.

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[100] For just some of the issues to account for, see: Bernard R. Wilson, "The Creditors' and Debtors' Guide to Survival and Success" (1995) 28 C.B.R. (3d) 25.

[101] Sellers, *supra*, note 81 at 328-29.

It is impossible to categorically state that the directors' charge should never cover pre-*CCAA* liabilities. There may be circumstances where such a broad indemnity and charge is necessary to retain the directors in circumstances where their services are essential and the liabilities are explicable. However, it should be clearly understood that such a situation is a preference to directors, and following from *Air Canada*, which creatively apportioning some liability to the directors personally rather than having all the liability absorbed by the directors' charge, methods can be fashioned to impose commercial morality constraints upon the directors.[102] Since the proposed section 11.51(1) in Bill C-62 appears to be limited to post-restructuring liability, this position might be too narrow to provide the flexibility that is the hallmark of the *CCAA* and often a necessary element of a restructuring. Existing insurance and indemnity provisions should already cover any such liability. Time will tell how courts will construe the statute and if the court's statutory discretion, gap-filling jurisdiction or inherent jurisdiction will allow it to supplement the statutory definition.

The most significant shortcoming of the proposed amendments deals with the relationship between the charge and existing directors' and officers' insurance. Section 11.51(3) provides: "The court may not make the order if in its opinion the company could obtain adequate indemnification insurance for the director or officer at a reasonable cost."[103] On its face, the proposed amendment does not seem to treat insurance as complementary to a charge, but rather as a substitute for it, and this approach is fraught with practical and conceptual problems. The proposed section 11.51(3) will need to be properly considered to recognize these realities and to preserve the complementary nature of the charge.

The better approach is to recognize in the initial order that the directors can only avail themselves of the directors' charge if there is evidence of insufficient or uncertain insurance coverage, or none at all.[104] This may not be a difficult test to meet in view of the prior discussion of the uncertainties associated with the existence and the extent of coverage at the outset of a

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[102] Settlements involving the United States insolvency proceedings of Enron Corp. similarly required some contributions be made by directors personally.

[103] Bill C-62, *supra*, note 7.

[104] This language is included in the Initial Order of *Collins & Aikman Products Co., Re* (15 May 2007), Toronto 07-CL-7027 (Ont. S.C.J. (C.L.)).

proceeding. In fact, is difficult to imagine circumstances where definitive evidence of insurance being "adequate" will be readily available.[105] This is a matter of fact however, so evidence will likely be necessary on the initial application with respect to any uncertainties over the extent of insurance coverage.

It should also be borne in mind that there is always a need for evidence to substantiate the basis of any directors' charge that is sought. If a directors' charge is sought due to a risk that directors may resign, it is often overlooked that proposed debtor companies should submit evidence of the risk of resignation to provide the factual basis for the arguments that a directors' charge is needed. This is particularly the case in light of arguments cited above that directors are often well-advised to remain at their posts to avoid liability and that they may simply be the type of people who do not wish to resign in any event. Often this evidence is not difficult to obtain and may simply involve a few paragraphs in the lead affidavit. But this is not always the case. If charges are to be tailored to the circumstances, counsel must ensure that the relevant facts are properly in evidence before the Court.

Finally, the limiting factor in allowing a directors' charge should be that existing rights should only be interfered with to the extent necessary to facilitate the *CCAA* process. The goal of the directors' charge ultimately is not to protect directors *simpliciter*, as such a view cannot see the forest for the trees. Instead, the goal is to allow companies to restructure themselves successfully. In our view, provisions like those in the Ontario Template CCAA Order strike a proper balancing of all interests.

10) Summary

The courts have recognized that the importance of directors to the restructuring process requires a hard look at ways to keep directors from resigning. With the potential for personal liability for directors, whether flowing from statutory obligations or from breaches of often

[105] The wording of proposed section 11.51(3) of Bill C-62 is: "The court may not make the order if in its opinion the company could obtain adequate indemnification insurance for the director or officer at a reasonable cost": Bill C-62, *supra*, note 7.

conflicting and ill-defined duties, directors require protections as an incentive to stay at their posts. These protections, in the form of indemnities, insurance, and court ordered charges, encourage directors to participate in the company's restructuring. This provides a benefit to the company by increasing the chances of it successfully restructuring and therefore benefits all stakeeholders.

However, since the goal of restructuring under the *CCAA* is to successfully restructure a company so that its various stakeholders may benefit, directors' charges should be tailored to promote this goal. A court's discretionary ability to grant a charge allows proper supervision over the company's restructuring and can encourage favourable outcomes. As described in the previous section, there are many factors that determine the proper scope of a directors' charge. Finding the right balance can be difficult, but can undoubtedly help promote a successful outcome. Despite upcoming codification, ongoing flexibility regarding directors' charges remains a crucial arrow in the judicial quiver to facilitate successful restructurings.