Deepening Insolvency in Canada?

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The Canadian legal landscape on corporate directors’ liability has been quiet since the release of the Supreme Court of Canada’s landmark decision in Peoples Department Stores Inc. (Trustee of) v. Wise. In Peoples, the Court decided against imposing a duty on directors to consider the interests of creditors when carrying out their fiduciary duties to a corporation approaching insolvency. It appears, however, that an American doctrine that holds directors and related third parties liable for “deepening the insolvency” of the corporation when its life has been wrongfully prolonged, and one that is on the radar in Canada, has the potential to affect the way Canadian courts view director liability. Peoples may have closed the door to imposing director duties to creditors but the American doctrine of “deepening insolvency”, if adopted in Canada, has the potential to do an end run around Peoples by indirectly providing protection for creditors when the corporation is facing insolvency.

The author discusses the implications of adopting the deepening insolvency doctrine in Canada and concludes that the doctrine is not necessary, as Canadian business law already has several functionally equivalent or similar remedies to address the harms deepening insolvency seeks to overcome. Most importantly, the oppression remedy, a doctrine deemed by the Supreme Court of Canada to deal with situations of near insolvency, could be expanded to address the concerns of creditors. Other potential avenues include claims for breach of fiduciary duties and duties of care, as well as claims for negligent or fraudulent misrepresentation.

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Introduction 169

I. Duties to Creditors of Corporate Directors in Canada 173

II. The Doctrine of Deepening Insolvency in the United States 175
   A. What is “Deepening Insolvency”? 175
   B. Recognition of Deepening Insolvency 179

III. Deepening Insolvency and the Business Judgment Rule 181

IV. Analysis: Canada's Adoption of Deepening Insolvency? 184
   A. Oppression Remedy: A Functionally Equivalent Canadian Doctrine 184
      1. What is the “Oppression Remedy”? 184
      2. Differences between the Oppression Remedy and Deepening Insolvency and Whether They Matter 184
         a. Identity of the Plaintiffs 185
         b. Identity of the Defendants 187
         c. Quantifying Damages 189
      3. Conclusion on Oppression Remedy 190
   B. Claim for Breach of Duty: Another Functionally Equivalent Canadian Doctrine 190
   C. Claim for Negligent or Fraudulent Misrepresentation: Similar but not Identical 193

Conclusion 197
Introduction

The Canadian legal landscape regarding the liability of corporate directors has been quiet since the release of the Supreme Court of Canada’s landmark 2004 decision in *Peoples Department Stores Inc. (Trustee of) v. Wise*. Prior to *Peoples*, the Canadian position had slowly been moving toward the recognition that directors’ fiduciary duties take into account the interests of creditors as a corporation approaches insolvency, a position similar to the statutory duty imposed in the United Kingdom under its “[w]rongful trading” provisions. This move was sharply halted when the Court in *Peoples* decided against imposing such duties and determined that although directors’ duties of care could encompass various constituents, their fiduciary duties are owed only to the corporation and do not change to encompass creditors as the corporation approaches insolvency.

It appears, however, that *Peoples* may not be the last word on the subject of Canadian directors’ liabilities in cases of looming insolvency. An American doctrine that holds directors and related third parties liable for “deepening the insolvency” of the corporation has the potential to affect the way Canadian courts view director liability. *Peoples* may have closed the door to imposing on directors duties to creditors, but the American doctrine of deepening insolvency, if adopted in Canada, has the potential to do an end run around *Peoples* by indirectly providing protection for creditors when the corporation is facing insolvency. This paper will discuss the implications of adopting the deepening insolvency doctrine and conclude that the doctrine is not necessary, as Canada already has remedies to address the harms deepening insolvency seeks to overcome.

The duty rejected in *Peoples* called for the consideration of creditors’ interests when a corporation is in the “vicinity of insolvency”. The duty imposed by the deepening insolvency doctrine is different. Deepening insolvency holds directors liable for harms suffered by the corporation when its life is wrongfully prolonged. The doctrine imposes on directors a duty to the corporation, but it also indirectly benefits creditors: first, by bringing money into the debtor’s estate to repay creditors if the claim against the directors is successful, and second, by restraining the actions of directors when the corporation is suffering financially, through the threat of liability.

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3. There are some statutory exceptions. For example, directors have duties to employees and can be held personally liable for unpaid wages (*Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 119 [*CBCA*]).
4. *Supra* note 1 at para. 46.
The doctrine of “deepening insolvency” originated in the United States in 1980\(^5\) and has gained ground most significantly in the last seven years. Since the seminal decision \textit{Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.}\(^6\) determined that deepening insolvency constituted a valid cause of action under Pennsylvania law,\(^7\) numerous claims for deepening insolvency have been made throughout the United States. The reactions of U.S. courts to these claims, however, have fallen along a spectrum and have ranged anywhere from recognition of the doctrine as an independent tort, to its recognition as a theory of damages, to a rejection of the doctrine altogether. The doctrine’s development has been a cautious and uneven one, but over the last twenty years its contours have been coming into focus and it has become, albeit somewhat grudgingly, a commonly recognized phrase in American jurisprudence.

Although jurisprudence on deepening insolvency has been gaining momentum, the doctrine’s validity was recently dealt a significant blow in the United States. The Supreme Court of Delaware, through its affirmation of the Delaware Chancery Court’s far-reaching decision in \textit{Trenwick American Litigation Trust v. Ernst & Young, LLP},\(^8\) refused to recognize deepening insolvency as a cause of action, leading some commentators to question whether the decisions have effectively brought an end to the deepening insolvency doctrine.\(^9\) While making a determination of this nature is still premature, the future of the deepening insolvency doctrine has been brought into question. That is not to say, however, that all proponents of the doctrine have fallen sway to the recent criticisms. Indeed, some commentators continue to believe that the doctrine remains a viable theory that can, and should, be salvaged. One commentator bases such a view on the well-known adage “bad facts make bad law” to explain the

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\(^5\) The concept of deepening insolvency originated in \textit{Re Investors Funding Corp.} (523 F.Supp. 533 (S.D.N.Y. 1980)), in which it was stated that “[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it” (ibid. at 541), but \textit{Schacht v. Brown} (711 F. 2d 1343 (7th Cir. 1983) [\textit{Schacht}]) was the first case to coin the phrase “deepening insolvency”. In \textit{Schacht}, the United States Court of Appeals for the Seventh Circuit determined:

\begin{quote}
[The premise] that the fraudulent prolongation of the corporation’s life beyond insolvency is automatically to be considered a benefit to the corporation’s interests ... collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability (ibid. at 1350).
\end{quote}


\(^6\) 267 F.3d 340 (3d Cir. 2001) [\textit{Lafferty}].

\(^7\) Ibid. at 350.

\(^8\) 906 A.2d 168 at 174 (Del. Ch. 2006), aff’d 2007 Del. LEXIS 357 (Del. Sup. Ct. 2007) [\textit{Trenwick}].

decision reached in *Trenwick*. Courts have also continued to recognize deepening insolvency, both as a viable doctrine and as a theory of damages. Subsequent to the *Trenwick* decision of the Delaware Chancery Court, the United States District Court for the Southern District of New York recognized that a claim for deepening insolvency would lie where the defendant either breached a duty owed to the company or “committed an actionable tort that contributed to the continued operation of [the] corporation and its increased debt.” With regard to use of the doctrine as a viable theory of damages, the United States Bankruptcy Court for the District of Columbia maintained that the “deepening of a company’s insolvency can be harmful,” and refused to disallow deepening insolvency as a viable theory of damages unless told otherwise by a higher court in its own circuit.

The lack of consistent treatment indicates that much has yet to be settled before the fate of the deepening insolvency doctrine in the United States is determined. However, regardless of the current unrest in the United States, questions about the doctrine’s application in Canada have made their way across the border, as Canadian lawyers continue to look at the doctrine’s functionality and applicability to Canadian law. Reports on the doctrine have questioned its “emergence north of the border,” noting that “the United States is often at the forefront before theories move north.” With “[e]xperience suggest[ing] that developments in the U.S. commercial laws tend to be imported north of the border,” restructuring bulletins have looked into whether the U.S. theory will be adopted in Canada and have concluded that, instead of recognizing the doctrine as a separate cause of action or a theory of damages, deepening insolvency claims could be made under the oppression remedy.

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14 Ibid.

Furthermore, the doctrine’s potential adoption in Canada has been the subject of debate at conferences in both Canada and the United States, one as recently as January 2008.\textsuperscript{16} It is apparent that regardless of the direction in which the doctrine is headed in the United States, deepening insolvency is on the radar in Canada. Contact between Canadian and American lawyers has been increasing along with the number of cross-border insolvencies. Such interaction, coupled with the availability of a doctrine that has been developing for over twenty years and has the potential to provide for the indirect protection of creditors and thus do an end run around \textit{Peoples}, indicates that it is a matter of time before an innovative lawyer attempts to make a deepening insolvency claim in Canada. And when that happens, judges will need to determine how claims for deepening insolvency will be handled.

To date there has been little or no academic analysis of whether Canada should adopt deepening insolvency. Because the idea of importing the doctrine into Canada may presently be enticing to some, the analysis in this article is thus necessary and timely. I will consider whether \textit{Peoples’} rejection of a doctrine similar to that found in the United Kingdom leaves a gap in Canadian law that could be filled with the American doctrine of deepening insolvency, and whether that would be a desirable outcome. My analysis will show that existing Canadian remedies are capable of dealing with the harm deepening insolvency seeks to overcome, such that the importation of the deepening insolvency doctrine is not necessary. Provided that courts recognize a slightly enlarged applicability of the principle, the oppression remedy may be a functional equivalent of deepening insolvency, as may a claim for breach of duty. Claims for fraudulent or negligent misrepresentation may also provide additional legal protection for certain creditors, though their similarities with deepening insolvency are less pronounced.

Part I will briefly discuss directors’ duties in Canada. Part II will examine the American position and explain the deepening insolvency doctrine, while Part III will consider some policy implications of adopting the rule, specifically with regard to the business judgment rule. Finally, Part IV will discuss whether Canada needs the deepening insolvency doctrine, or whether it should be rejected on the basis that it is functionally equivalent to existing remedies in Canadian law.

I. Canadian Directors’ Duties to Creditors

Under subsection 122(1)(a) of the Canada Business Corporation Act, each director owes a fiduciary duty to the corporation, sometimes known as a duty of loyalty, to act honestly and in good faith with a view to the corporation’s best interests. Separate from this fiduciary duty, each director and officer also has a duty to “exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances” pursuant to subsection 122(1)(b) of the CBCA, a requirement generally referred to as the “duty of care.”

Originally, directors had no duties to creditors and could ignore creditors’ interests, subject only to tort and contract rules. This continued to be the predominant view in Canada until Re Trizec Corp., which dealt with an application for approval of a proposed plan of arrangement. Trizec was pivotal because it signalled a significant shift in the traditional concept of directors’ duties. Rather than directors owing duties only to the corporation, Justice Forsyth determined that “a specific duty to shareholders becomes intermingled with a duty to creditors when the ability of a company to pay its debts becomes questionable.” The shift toward the perception that directors’ duties extend to creditors as a corporation approaches insolvency gained support with the trial court decision in Peoples, in which Justice Greenberg found the corporation’s directors personally liable for having breached their duties to creditors. He relied on U.K., Australian and New Zealand jurisprudence to determine that Canadian directors’ duties in subsection 122(1) of the CBCA should extend to the corporation’s creditors when the corporation is insolvent or close to insolvency. However, the Quebec Court of Appeal overturned the trial judge’s decision and noted that expanding the scope of directors’ duties was a legislative issue, not one for the courts.

17 Supra note 3.
18 Ibid. Corporate statutes in each province also impose similar duties.
21 Ibid. at para. 42.
The dismissal of the subsequent appeal by the Supreme Court of Canada in *Peoples* sharply halted the expansion of directors’ duties. The Court held that a director’s statutory duty of loyalty to the corporation does not extend to creditors, even when the corporation is approaching insolvency. Rather, as directors attempt to alleviate a corporation’s financial difficulties, they must act with honesty and in good faith in the best interests of the corporation. In so doing, directors will not have breached their statutory fiduciary duty, regardless of whether or not they manage to save the corporation.\(^{24}\) Therefore, it is now settled law in Canada that no director is statutorily required, or allowed, to make a decision based on any other interest when discharging his or her fiduciary duty.

The Court specifically considered U.K. law and rejected a similar application in *Peoples*. Under English law, it has been the case since the late 1980s that in addition to the duty to act in the best interest of the company, directors also have duties to consider creditors’ interests, both at common law\(^{25}\) and under the statutory “[w]rongful trading” provisions.\(^{26}\) Under the wrongful trading provisions, upon an application by a liquidator, a court may declare directors liable to make personal contributions to the company’s assets in the course of the company’s winding up if the directors failed to have the company cease trading as it approached insolvent liquidation.\(^{27}\)

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\(^{24}\) *Supra* note 1 at para. 67.


\(^{26}\) *Insolvency Act 1986*, *supra* note 2, s. 214(1).

\(^{27}\) The history behind the wrongful trading provisions is worthy of note. Before 1985, when the wrongful trading provisions were enacted, directors could be held criminally and civilly liable for fraudulent trading, which required a finding of “intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose” (*Companies Act, 1948* (U.K.), 11 & 12 Geo. VI, c. 38, s. 332(1), now s. 213(1) of the *Insolvency Act 1986*, *ibid*.). Due to the subjective nature of the imposition of liability, that law was perceived to be inadequate. See U.K., H.C., “Insolvency Law and Practice: Report of the Review Committee”, Cmdn 8558 in *Sessional Papers* (1981-82) 1 at para. 1782 [Cork Report]. The Cork Committee therefore sought to establish a lower threshold for a finding of liability by imposing civil liability on directors for wrongful trading, such that an honest but unreasonable action would leave directors open to personal liability (*ibid*.). More accountability on the part of directors would thus be encouraged, requiring them to ensure the presence of adequate funds prior to making decisions to continue trading, and to take immediate steps to put the company into liquidation, receivership or administration on the insolvency of the company. The Cork Report recommended the imposition of an objective test. The standard to be applied to directors would be that
There is no equivalent to these wrongful trading provisions in Canada. Following the Supreme Court of Canada’s refusal in Peoples to recognize a duty to creditors as the corporation approaches insolvency, Canadian creditors may fear insufficient protection for their interests and, consequently, may be prompted to bring the American deepening insolvency action into Canadian courts. While the potential benefit to creditors as a result of the deepening insolvency claim is indirect, because the action is based on harm done to the corporation, creditors would eventually profit if money is brought into the corporation by virtue of a successful action.

II. Position in the United States

In 1983, the term “deepening insolvency” was coined when the United States Court of Appeals for the Seventh Circuit recognized the damage that can be accrued when management continues to operate an insolvent corporation. Since then, the doctrine has been widely considered and has been the subject of numerous claims. As indicated earlier, while recent decisions have put the future of the doctrine into question, the contours of the doctrine have nonetheless been taking shape within the large body of jurisprudence that has accumulated over the last twenty years.

A. What is “Deepening Insolvency”? 

“Deepening insolvency” is a nonstatutory doctrine that does not appear anywhere in the Bankruptcy Code. The absence of a statutory definition renders the doctrine uncertain in scope and consequently, deepening insolvency has neither been of the “ordinary, reasonable man” and what he would have done in the circumstances (ibid. at paras. 1783, 1790).

The Department of Trade and Industry accepted the recommendation for the imposition of liability for wrongful trading (U.K., H.C., “A Revised Framework for Insolvency Law”, Cmd 9175 in Sessional Papers (1983–84) 1 at 28). It determined that during a winding up, if it was found that directors had continued to trade and the existing creditors of the company were, as a result, in a worse financial position or that new, unpaid liabilities had been incurred by the company during that time, then the directors who knew, or ought to have known, that the company could not reasonably have avoided that situation would be personally liable for the loss suffered by creditors (ibid.). Due to the legislative reforms in 1985–86, the criminal provision became s. 458 of the Companies Act 1985 ((U.K.), 1985, c. 6) and the civil sanctions became ss. 213-15 of the Insolvency Act 1986 (supra note 2) for fraudulent and wrongful trading (Davies, supra note 25 at 194).

28 Schacht, supra note 5 at 1350.
29 In addition to the sources cited in supra notes 7-8, see also North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. Sup. Ct. 2007) [Gheewalla]. The Gheewalla decision determined that creditors have no right to bring a direct claim against directors for breach of fiduciary duty, and did not comment on deepening insolvency. Nonetheless, some critics are combining Gheewalla with Trenwick to show the Delaware courts’ proclivity against finding director duties to creditors when the company is in the vicinity of insolvency or altogether insolvent.
universally defined nor applied, nor has it been universally accepted in the United States. However, several important cases have contributed to the development of the theory, and while these cases have not necessarily served as precedents for all others, they constitute the theoretical foundation upon which the different conceptions of the deepening insolvency theory have been constructed. To date, deepening insolvency has been accepted as an independent cause of action, as a cause of action that “piggy-backs” onto other claims (namely breach of fiduciary duty), or as a theory of damages. Some courts have also completely rejected the theory.

Directors, officers or other parties who exercise control over the corporation engage in deepening insolvency when they wrongfully incur further corporate debt while the corporation is insolvent and has no reasonable prospect of recovering. Deepening insolvency is premised on the acknowledgment that incurring such debt harms the corporation. Accordingly, the harm brought about by directors’ failure to stop trading under the above circumstances can be avoided through the creation of personal liability under the doctrine of deepening insolvency. The objective of the

32 Although Trenwick has rejected the prospect that deepening insolvency can be used as an independent cause of action (supra note 8 at 205).
33 This topic will be discussed later. For now, it is sufficient to say that in Rahl v. Bande (328 B.R. 387 (Bankr. S.D.N.Y. 2005)), Sharp v. Hawkins (2004 WL 2792121 (N.D. Cal. 2004) (WL)), and Re RSL COM Prime-Call Inc. (2003 WL 22989669 (Bankr. S.D.N.Y. 2003) (WL) [Re RSL COM]), the complainants treated deepening insolvency as a breach of fiduciary duty, claiming that the defendants had breached their fiduciary duties to the corporation by wrongfully prolonging its life.
34 As a theory of damages, deepening insolvency is seen as a form of injury to the company and its creditors, compensable under established causes of action (e.g. breach of fiduciary duty by the company’s directors and in respect of the third parties such as lenders, actions against such persons for aiding and abetting or conspiring in the breach of the directors’ fiduciary duties) and measured by the extent of the company’s “deepened insolvency” (Rostom, Kent & Weerasooriya, supra note 15 at 2).

36 Salomon v. Salomon and Co. is commonly (but mistakenly) referenced as the origin of limited liability ([1895–99] All E.R. 33, [1897] A.C. 22 (H.L.) [Salomon]). Salomon was based on the creation of corporate-like personality for English Registered Companies and only dealt with the limited liability of shareholders and not directors. Limited liability for shareholders in the United Kingdom was conferred by The Limited Liability Act, 1855 and the term “limited liability” referred to the amount remaining unpaid on their shares, as opposed to a reference to their immunity ((U.K.), 18 & 19 Vict., c. 133). Accordingly, in jurisdictions that preclude shares from being issued on a partly-paid or unpaid basis, the term “limited liability” is incorrect and “shareholder immunity” is preferred, as is found in the CBCA (supra note 3, s. 45). However, limiting the personal liability of directors has
liability imposed by the doctrine is to motivate directors to recognize this harm and cease trading as soon as saving the corporation is no longer a feasible prospect.\(^{37}\) As the United States Court of Appeals for the Seventh Circuit noted in Schacht:

\[\text{[A]cceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible.}\(^{38}\)

Without the threat of personal liability, directors may be no worse off even if they continue to incur debt when the corporation is insolvent. Even if it is unlikely that the corporation could trade into a profitable financial state, directors have an incentive to take that chance. If they are successful, they will once again have a profitable corporation; they will keep their jobs and, if they are also shareholders, regain value in their shares. If they are unsuccessful, other than the damage done to their reputations as directors, they will suffer no additional financial loss because the limitation of their liability ensures that they are not responsible for the corporation’s debts.

While the deepening insolvency claim ends up protecting creditors, because their injury results indirectly from injury to the corporation,\(^{39}\) the actual claim is brought by the corporation to address the harm that has been done to it.\(^{40}\) Accordingly, the right of action must belong to the debtor corporation, not to the creditors.\(^{41}\) The injury suffered in a deepening insolvency situation was defined in Lafferty as “an injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.”\(^{42}\) Generally, additional harm can include artificially propping up the debtor, which delays bankruptcy.\(^{43}\) Specifically, the injury caused to the corporation can include the decline in value of the remaining corporate assets through the incurrence of additional debt.\(^{44}\) It can cause a hastening of bankruptcy through the dissipation of corporate assets\(^{45}\) and an undermining of the relationships

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also been recognized by the law. For a further discussion on the intended beneficiaries of limited liability, see Christopher C. Nicholls, “Liability of Corporate Officers and Directors to Third Parties” (2001) 35 Can. Bus. L.J. 1 at 1-4.


\(^{38}\) Supra note 5 at 1350.

\(^{39}\) See Re Buildnet, Inc., 2004 WL 1534296 at 2 (Bankr. M.D.N.C.) [Buildnet].

\(^{40}\) See Abbott, Radasevich & Shapiro, supra note 31 at 538.

\(^{41}\) Lafferty, supra note 6 at 347-49. See also ibid.

\(^{42}\) Ibid. at 347.

\(^{43}\) OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.), 340 B.R. 510 at 532 (Bankr. D. Del. 2006) [Oakwood Homes].


\(^{45}\) Ibid.
between the corporation and its “customers, suppliers, and employees”. Due to the broad definition of deepening insolvency, while the claim is usually brought against directors and officers, it may include other defendants such as lenders or auditors.

Nevertheless, to fall within the scope of the deepening insolvency doctrine, the prolongation of the corporation’s life must usually have been the result of fraud. In Schacht, the court defined deepening insolvency as involving the “fraudulent prolongation of a corporation’s life beyond insolvency.” The court in Lafferty described it as “an injury to the Debtors’ corporate property from the fraudulent expansion of corporation debt and prolongation of corporate life,” while the court in Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp. stated that “deepening insolvency occurs where corporate property is injured through the fraudulent or concealed expansion of corporate debt and prolongation of corporate life.” Some cases have suggested that the deepening insolvency threshold is met with a finding of negligence. However, the court in Kittay v. Atlantic Bank (Re Global Service Groups LLC) held that under the business judgment rule, if directors and officers continue to operate an insolvent corporation in good faith, they will not be subject to liability for deepening insolvency. Therefore, while it is possible to argue for deepening insolvency based on negligent conduct, depending on the extent of the negligence, the business judgment rule could effectively cancel the deepening insolvency claim, provided that the directors acted diligently and in good faith.

46 Lafferty, supra note 6 at 350.
47 For example, in Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies) (299 B.R. 732 (Bankr. D. Del. 2003) [Exide Technologies]) and Oakwood Homes (supra note 43), the deepening insolvency claims were brought against the lenders who exercised control over the debtor corporation, and in Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.) (269 B.R. 721 (Bankr. S.D. Fla. 2001) [Flagship Healthcare]), the court denied a motion to dismiss a deepening insolvency claim brought against the debtor’s auditing firm for having negligently prepared an auditing report.
48 Supra note 5 at 1350.
49 Supra note 6 at 347.
50 Supra note 44 at 12.
51 In Limor v. Buerger (In re Del-Met Corp.), the court, quoting Jo Ann J. Brighton (“Deepening Insolvency” (April 2004) 23 Am. Bankr. Inst. J. 34 at 34), accepted the notion that deepening insolvency may occur when the defendant negligently prolongs the corporation’s life (322 B.R. 781 at 812 (Bankr. M.D. Tenn. 2005)). See also Gourian Holdings, Inc. v. DeSanits, Princi, Springer, Keifer & Shall (In re Gourian Holdings), 165 B.R. 104 at 107 (E.D.N.Y. 1994) (reversing the grant of a motion to dismiss a claim for negligent preparation of financial statements that may have resulted in the debtor “incurring unmanageable debt and filing for bankruptcy protection”); Bondi v. Citigroup, supra note 31; Flagship Healthcare, supra note 47; Re CitX Corp., Inc., 448 F.3d 672 at paras. 9-10 (3d Cir. 2006) (acknowledging the support for the argument but ultimately refusing to expand the scope of deepening insolvency to include negligence).
52 316 B.R. 451 (Bankr. S.D.N.Y. 2004) [Global Service]. For further discussion of the business judgment rule, see Part III.
53 Ibid. at 460.


B. Tort or Non-Tort?

There are several cases that have contributed to the development of the deepening insolvency doctrine. The phrase “deepening insolvency” was pioneered in 1983 in Schacht, which dealt with an interlocutory appeal from the United States Court for the District of Delaware’s denial of the defendants’ motion to dismiss the claim brought against them. The plaintiff, a statutory liquidator, claimed that the fraudulent actions of the defendants, the directors and officers, caused the Corporation, Reserve Insurance Company (Reserve), to continue conducting business even though it was insolvent, leading Reserve to accrue greater liabilities and “drive it deeper into insolvency,” causing damage to Reserve, its creditors and policy holders.54 The court upheld the denial of the motion to dismiss, finding that the corporation could be damaged by the deepening of its insolvency since this circumstance further exposed the corporate entity to creditor liability.55

Since Schacht, numerous decisions on deepening insolvency have been rendered. In Lafferty, one of the most influential judgments, a committee of creditors was authorized to pursue a claim on behalf of the two debtor corporations after a Ponzi scheme56 was discovered. The claim was brought against the debtors’ officers, directors, affiliated corporations, outside professional accountants, and underwriters, alleging that the third parties had conspired with the debtors’ management to fraudulently induce these corporations to issue debt certificates, thereby deepening the latter’s insolvencies. The court found that deepening insolvency gives rise to cognizable injury, injury that can be avoided “if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.”57 Accordingly, Lafferty recognized deepening insolvency as a cause of action.58

In Global Service the plaintiff trustee brought a claim for deepening insolvency against the senior management of Global Service Group, LLP (Global) and against its lender, Atlantic Bank. The trustee alleged that the management had allowed Global to operate and incur debt while it was insolvent, and that “[b]y prolonging the debtor’s

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54 Supra note 5 at 1345.
55 Ibid. at 1350.
56 A Ponzi scheme is a fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, [usually] without any operation or revenue-producing activity other than the continual raising of new funds (Black’s Law Dictionary, 8th ed., s.v. “Ponzi scheme”).
57 Supra note 6 at 350. Subsequently Exide Technologies relied on the reasoning in Lafferty to recognize a cause of action for deepening insolvency in Delaware (supra note 47). In Oakwood Homes the United States Bankruptcy Court for the District of Delaware also followed Lafferty to determine that Delaware, New York and North Carolina courts would recognize deepening insolvency as a cause of action (supra note 43 at 531).
58 Ibid. at 351.
corporate life and incurring more debt, the [management] deepened Global’s insololvency, and reduced any potential recovery for the creditors of the debtor’s bankruptcy estate.”59 The trustee also alleged that Atlantic Bank knew or should have known that Global, an insolvent corporation, would be unable to pay back the money loaned to it.60 The United States Bankruptcy Court for the Southern District of New York found that the prolongation of an insolvent corporation’s life, without more, would neither constitute an independent tort nor a theory of damages.61 Rather, to successfully claim deepening insololvency, a claimant “must show that the defendant prolonged the company’s life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.”62 Simply put, the court found directors to be under no duty to liquidate an insolvent corporation, and failure to do so does not open them up to liability. Rather, the decision to continue operating an insolvent corporation is protected by the business judgment rule, which can only be overcome with allegations that the “fiduciary had acted in bad faith or with fraudulent intent.”63

Similarly, the court refused to accept deepening insololvency as a claim in Bondi, commenting that it is the responsibility of the legislature or the Supreme Court of the United States to create new causes of action.64 The Court of Appeals for Utah also refused to recognize a claim for deepening insololvency that had been put forth by the plaintiff as a theory of damages, finding that while deepening insololvency might harm the shareholders of the corporation, it does not harm the corporation itself.65 Finally, the Court of Chancery of Delaware refused to recognize the claim as a “coherent concept”, noting that the law already required directors of an insolvent corporation, as fiduciaries, to consider the interests of creditors.66

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59 Supra note 52 at 456.
60 Ibid. at 455.
61 Ibid. at 458.
62 Ibid.
63 Ibid. at 461.
64 Supra note 34.
65 Coroles, supra note 35 at 983.
66 Trenwick, supra note 8 at 174. In the United States, directors owe their fiduciary duties of care and loyalty to the corporation and its shareholders. See Smith v. Van Gorkom, 488 A.2d 858 at 872 (Del. Sup. Ct. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 at 955 (Del. Sup. Ct. 1985) [Unocal]; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 at 179 (Del. Sup. Ct. 1986); Aronson v. Lewis, 473 A.2d 805 at 811 (Del. Sup. Ct. 1984) [Aronson]. In a solvent corporation, directors are expected to act in a manner that maximizes the value of the corporation for the corporation and its “owners”, the shareholders. However, once a corporation enters the vicinity of insolvency, the Delaware Court of Chancery’s decision in Credit Lyonnais Bank Nederland, N.Y. v. Pathe Communications Corp. established that those duties shift to encompass creditors’ interests (1991 WL 277613 (Del. Ch. 1991) (WL) [Credit Lyonnais]). While some commentators have interpreted Credit Lyonnais to have created a new duty owed directly to creditors upon a corporation’s insolvency, the prevailing view has determined that there is no specific duty to creditors at any time and the duty to consider creditors’ interests is one that is owed to the corporation. See Production
In summary, while most American courts that have accepted the claim are in agreement that deepening insolvency involves the fraudulent (or sometimes negligent) prolongation of the corporation’s life, there is no clear delineation with regard to how deepening insolvency can be used as a claim. Even if the courts were to settle on treating deepening insolvency as a tort claim, its elements would still have to be defined. In addition, its treatment as a tort claim would necessitate the difficult task of showing causation and the amount of harm done by the tort—the amount by which the corporation’s insolvency was deepened.67

The doctrinal uncertainty of the deepening insolvency doctrine, and its potential overlap with several Canadian doctrines that could also be used to address the wrongful prolongation of a corporation’s life, indicate that Canada should not be too hasty to adopt deepening insolvency.

III. Deepening Insolvency and the Business Judgment Rule

Imposing liability on directors of an insolvent company raises concerns that courts may, through the wisdom of hindsight, find directors liable for implementing, or failing to implement, certain policies at the time the corporation began encountering financial difficulty. Should that happen, directors’ fear of liability could lead to overdeterrence, or what has been described as a “blanket duty to liquidate upon insolvency”:68 directors, concerned about incurring liability for the wrongful prolongation of the corporation’s life during their attempts to “rescue” it, may forego this opportunity and liquidate too early. Hence, while the deepening insolvency doctrine seeks to compel directors to take steps to minimize the loss to the company only once they know there is no reasonable prospect of avoiding insolvent liquidation, directors may nonetheless be inclined to put the company into liquidation earlier than necessary in order to ensure the avoidance of liability.

While concerns over the potential diminishment of the business judgment rule if deepening insolvency were to be adopted may be warranted, the concern about exposing directors to additional liability is somewhat indefensible. From a policy

68 Abbott, supra note 16 at 11.
perspective, although deepening insolvency could potentially expand the realm of liability for third-party professionals, it likely would not do so for directors.

Short of engaging in fraudulent or wrongful conduct, a board of directors is under no obligation to liquidate an insolvent company,69 a concept that would not change with the adoption of the deepening insolvency doctrine. Rather, as the court in Trenwick stated, “even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm,”70 an approach that is consistent with the goals underlying Chapter 11 and that can result in turning the corporation into a profitable entity.71 If directors implement a diligent and good-faith strategy geared toward saving the company, even one that causes the corporation to incur more debt, the behaviour will not give rise to a cause of action because the directors will be protected under the business judgment rule.72 The business judgment rule, a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company,”73 ensures that courts refrain from substituting their own judgment for that of directors so long as the directors were prudent, diligent and carried out the decision in good faith. A finding of fraud, however, which is required by most courts for a deepening insolvency action as it currently stands, would automatically rebut the business judgment rule, which only applies to decisions carried out in good faith. The protection provided under the business judgment rule relieves the concerns about overdeterrence.

Notably, in support of this point, the behaviour targeted by deepening insolvency, the fraudulent concealment of the corporation’s faltering financial status in an effort to acquire more corporate debt, has most commonly been caught by other doctrines, such as fraud or breach of fiduciary duty. This duplication was acknowledged in Trenwick:

The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud...

...No doubt the fact of insolvency might weigh heavily in a court’s analysis of, for example, whether the board acted with fidelity and care in deciding to undertake more debt to continue the company’s operations, but that is the

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69 Support for this proposition is much clearer in the United States than in Canada. In the United States, courts have clearly articulated this principle. See Trenwick, supra note 8 at 204; Global Service, supra note 50 at 460. In Canada, as the corporation approaches insolvency, directors must continue acting in the best interest of the corporation, an obligation capable of encompassing the American approach.
70 Ibid. at 204.
71 Ibid.; Global Service, supra note 52 at 460.
72 See e.g. Trenwick, ibid. at 205; Global Service, ibid.
73 Aronson, supra note 66 at 812; Unocal, supra note 66 at 954 (citing Aronson).
proper role of insolvency, to act as an important contextual fact in the fiduciary duty metric. In that context, our law already requires the directors of an insolvent corporation to consider, as fiduciaries, the interests of the corporation’s creditors who, by definition, are owed more than the corporation has the wallet to repay.”

If a lowered threshold were to become the acceptable norm for asserting a deepening insolvency claim, such that a finding of fraud were no longer required, the issue would be with regard to how the business judgment rule would apply to a deepening insolvency claim. The answer would depend on the level of negligence that would be required to meet the lowered threshold. If only basic negligence is required, the business judgment rule would likely become inapplicable since the claim itself would require courts to examine the very types of decisions specifically precluded from examination under the rule, namely those made negligently, even if made diligently and in good faith. It is likely the case, however, that these fears are unfounded. A threshold requiring negligence for a deepening insolvency claim would likely be limited to situations involving extreme negligence, lacking diligence and good faith, in which case the application of the business judgment rule as it currently stands would remain intact.

Potential problems may arise with regard to the coverage provided by the business judgment rule. The business judgment rule can only protect directors exercising managerial authority. The deepening insolvency action has been brought not only against directors, but also against third-party professionals who provide advice to directors and who would not benefit from the protection of the business judgment rule. Finally, if the deepening insolvency action were to be classified as an independent tort, and not a “business decision”, the business judgment rule may not apply.

Concerns regarding overdeterrence do raise several important issues. However, if courts approach decisions relevant to deepening insolvency claims like any other managerial decision, and if the threshold leans more toward fraudulent conduct rather than negligent behaviour, the concerns are not as significant as they first appear.

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75 See Harrell, supra note 64 at 153; Thompson, supra note 66 at 546.
76 Kevin Patrick McGuinness, Canadian Business Corporations Law, 2d ed. (Markham, Ont.: LexisNexis, 2007) at paras. 11.15-11.25 (discussing the business judgment rule).
77 See Harrell, supra note 67 at 153. The business judgment rule applies to “business decisions” and strategies of directors and has, for the most part, been utilized when judges assess whether directors have carried out their duties to the corporation. It is unclear whether the business judgment rule would protect directors if deepening insolvency were to be classified as a tort, independent of directors’ duties.
IV. Analysis: Canada’s Adoption of Deepening Insolvency?

In considering whether deepening insolvency has a place in Canadian jurisprudence, both muddying the Canadian legal waters with a doctrine that has yet to be defined in its country of origin as well as the potential danger of overlap between an American legal doctrine and existing domestic law should give us pause for consideration. Indeed, the doctrine would add little to Canadian law because the recognition of deepening insolvency would mean the duplication of several obligations that already exist for Canadian directors.

A. Oppression Remedy: A Functionally Equivalent Canadian Doctrine

1. What is the “Oppression Remedy”?

In Peoples, the Supreme Court of Canada claimed that directors’ duties toward creditors are not necessary, given that creditors already have the oppression remedy.78 The oppression remedy can be granted when the court is satisfied that the corporation or its directors acted in a way that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, any security holder, creditor, director, or officer.79 “Oppressive” conduct has been defined as “burdensome, harsh and wrongful,” “unfairly prejudicial” as “inequitable or unjust,” and “unfairly disregarding” as “unjustly or without cause ... paying no attention to the interests of creditors.”80

2. Differences between the Oppression Remedy and Deepening Insolvency and Whether They Matter

The deepening insolvency doctrine and the oppression remedy differ with regard to the identity of the plaintiffs and defendants and the quantification of damages. Regardless of these differences, the oppression remedy, provided it is slightly

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78 See Peoples, supra note 1 at paras. 47-51. Unsecured creditors do not have automatic standing to pursue the oppression remedy but the courts have been known to grant them status to bring a claim. The requirements that have to be met are set out throughout this section.

79 The requirements are set out in s. 241(2)(c) of the CBCA (supra note 3) and under all provincial statutes except Prince Edward Island’s. See Business Corporations Act, R.S.A. 2000, c. B-9, s. 242(2) [ABCA]; Corporations Act, R.S.M. 1987, c. C255, C.C.S.M. c. C255, s. 234(2); Business Corporations Act, S.N.B. 1981, c. B-9.1, s. 166(2); Corporations Act, R.S.N.L. 1990, c. C-36, s. 371(2); Companies Act, R.S.N.S. 1989, c. 81, s. 5(2); Business Corporations Act, R.S.O. 1990, c. B.16, s. 248(2) [OBCA]; Business Corporations Act, R.S.S. 1978, c. B-10, s. 234(2); Business Corporations Act, R.S.Y. 2002, c. 20, s. 243(2); The Business Corporations Act of British Columbia protects only shareholders “or any other person whom the court considers to be [appropriate]” (S.B.C. 2002, c. 57, ss. 227(2), 228(1)).

broadened, can serve the same purpose as the deepening insolvency doctrine, rendering the latter unnecessary in Canadian law. In fact, the Court of Queen’s Bench of Manitoba has already suggested that misleading creditors with regard to the corporation’s financial status, when directors know or ought to know that the corporation is insolvent or becoming insolvent, classifies as “oppressive” or “unfairly prejudicial” conduct.81

a. Identity of the Plaintiffs

The first difference arises with regard to the identity of the plaintiffs. The theory behind the deepening insolvency doctrine is that the claim must necessarily involve harm done to the corporation, leading to the requirement that only a corporation, or someone on the corporation’s behalf, can bring an action for deepening insolvency.82

The oppression remedy is broader such that virtually anyone can be granted status as a “proper person”83 to pursue the remedy at the courts’ discretion. The definition of “proper person” has been broadly interpreted to include creditors,84 and Canadian creditors have been allowed to bring applications for the remedy on numerous occasions,85 even though unsecured creditors do not have the status as of right since they are not included in the statutory definition of “complainant” under the CBCA.86 Courts have granted the necessary standing to Canadian creditors, and to trustees representing them, in cases in which directors failed to consider their interests.87

The oppression remedy was enacted, inter alia, to protect minority shareholders’ reasonable expectations, as their exclusion from elections or general meetings...
rendered them unable to make managers account for their actions.88 Creditors are in a similar position: they do not elect directors, but directors can act in ways that prejudice them as the company approaches insolvency.89 Accordingly, complainant status can be granted to an applicant “if the act or conduct of the directors or management of the corporation which is complained of constituted a breach of the underlying expectation of the applicant arising from the circumstances in which the applicant’s relationship with the corporation arose.”90

Prior to Peoples, creditors usually brought successful oppression remedy claims in cases where directors of closely held corporations transferred assets beyond creditors’ reach; generally, the remedy was unavailable in cases in which the corporation was mismanaged by directors.91 However, since Peoples, the potential for protection of creditor interests lies in the “unfairly disregards” or “unfairly prejudicial” portion of the remedy and determining whether managerial actions fall into those categories will thus depend on how the courts define creditors’ reasonable expectations.92

Determining a creditor’s “underlying expectation” involves an inquiry into whether, inter alia, the creditor “entertain[ed] an expectation that, assuming fair dealing, its chances of repayment would not be frustrated by the kind of conduct which subsequently was engaged in by the management of the corporation.”93 It also involves an inquiry into whether the creditor was prevented from taking steps, when it entered into the credit agreement, “to protect his or its interests against the occurrence of which he or it now complains.”94

A creditor will not be granted complainant status if its interests are too remote or “where the complaints of a creditor have nothing to do with the circumstances giving rise to the debt[,] or if the creditor is not proceeding in good faith.”95 Generally, the remedy is available to a creditor when directors or management have been using the

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91 Sarra, “Peoples’ Choice”, supra note 88 at 132.
92 Ibid. at 132-35.
93 First Edmonton, supra note 90 at 152. See also David Thomson, “Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not To Oppress?” (2000) 58 U.T. Fac. L. Rev. 31 (tracing the jurisprudence that has established the “legitimate interest” test). For an application of the test, see Re Daon, supra note 89; Jacobs Farms, supra note 89; Royal Trust Corp. of Canada v. Hordo (1993), 10 B.L.R. (2d) 86, 41 A.C.W.S. (3d) 809 (Ont. Ct. J. (Gen. Div.)) [Hordo cited to B.L.R.]; Levy-Russell, supra note 85.
94 First Edmonton, supra note 90 at 152.
95 Hordo, supra note 93 at para. 14.
corporation to commit fraud on the creditor, or to protect a creditor’s underlying reasonable expectation of repayment when such expectation is frustrated by the conduct of management.\textsuperscript{96} Bad faith need not be proven for the courts to find oppressive conduct.\textsuperscript{97}

Allowing the oppression remedy to be brought by creditors is the way in which the remedy may be employed to achieve the results made available by the deepening insolvency doctrine. Even though the corporate plaintiff in a deepening insolvency claim seeks to right the harm done to itself, such a claim still indirectly protects creditors because their injury results indirectly from injury to the corporation.\textsuperscript{98} Further, it indirectly benefits the creditors because the money gained from a successfully prosecuted action goes into the debtor’s estate and back out to repay the creditors:

\begin{quote}
[A] corporation can suffer an injury unto itself, and any claim it asserts to recover for that injury is independent and separate from the claims of shareholders, creditors, and others. We think it is irrelevant that, in bankruptcy, a successfully prosecuted cause of action leads to an inflow of money to the estate that will immediately flow out again to repay creditors.\textsuperscript{99}
\end{quote}

Therefore, the identities of the plaintiffs are merely procedural differences and do not lead to substantially different outcomes between the doctrines.

\textbf{b. Identity of the Defendants}

The second difference between the doctrines arises with regard to the identity of the defendants. As discussed above, the breadth of the deepening insolvency doctrine allows anyone who participated in the deepening insolvency of the corporation to be named as a defendant. While a claim for an oppression remedy is generally brought against directors or the corporation (or both), it is possible to interpret the oppression remedy in a similarly broad context and thus to allow for the joining of third parties as defendants. Subsection 241(2) of the \textit{CBCA} allows for a complainant to make an application under the following circumstances:

\begin{enumerate}
\item A complainant may apply to a court for an order under this section.
\item If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates
\begin{enumerate}
\item any act or omission of the corporation or any of its affiliates effects a result,
\end{enumerate}
\end{enumerate}


\textsuperscript{98} \textit{Buildnet, supra} note 39 at 7.

\textsuperscript{99} \textit{Lafferty, supra} note 6 at 348-49.
(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.100

The powers granted under the oppression remedy are significant and courts are granted “very broad” discretionary power to award “any interim or final order [they] think fit ... ”101 The provision widely targets acts or omissions of the corporation,102 the “business or affairs” of the corporation,103 and the “powers of the directors”.104 And, even though the statute does not explicitly provide for bringing a claim against third parties, such a claim can arguably fall under the “business or affairs” portion of the provision. “Affairs” of the corporation, as defined by the CBCA, means “the relationships among a corporation, its affiliates and the shareholders, directors and officers of such bodies corporate but does not include the business carried on by such bodies corporate.”105 However, “business” is not defined.106 Arguably, since “affairs” refers to the relationships within the corporation and between the insider parties enumerated in subsection 241(2) of the CBCA, “business” could encompass those relationships between the corporation and the outsiders who inform, assist and are relied upon by those conducting the “affairs” of the corporation, such as auditors, accountants, lawyers and lenders. Bruce Welling has also argued that the phrase “business and affairs” includes all decisions made by a corporation,107 and Justice Doherty, in *Budd*, noted that the provision “serves as a judicial brake against abuse of corporate powers, particularly, but not exclusively, by those in control of a corporation and in a position to force the will of the majority on the minority.”108 Directors are not presumed to be experts in conducting corporate business; it is expected they will rely on the advice and reports of parties outside the corporation to perform acts for, and on behalf of, the corporation. In summary, while courts have yet

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100 *Supra* note 3, ss. 241(1–2).
103 *CBCA, ibid.*, s. 241(2)(b).
108 *Supra* note 101 at para. 32 [emphasis added].
to develop a definition for “business” in the CBCA, it could be interpreted to include the activities conducted by third parties to inform and influence the corporation.

c. Quantifying Damages

Finally, quantifying damages will pose problems under both the U.S. and Canadian doctrines, but the principles of quantification offered by the oppression remedy give courts broad discretion to make an order.

The principles that drive a damages qualification for deepening insolvency are as follows: “(1) Dissipation of assets or increased debt load and (2) impact on business operations and relationships.”109 But while it may be simple to articulate the principles, the actual determination of the loss of value to the corporation as a result of the deepening of its insolvency will prove to be a factually difficult process. Drabkin found that damages resulting from keeping the debtor alive while insolvent are compensatory, but also that proving such damages remains difficult.110 Commentators have noted that causation problems arise in trying to determine which assets were dissipated as a result of directors’ actions and which would have occurred regardless of those actions, while also noting that an increase in the amount of debt does not necessarily translate into damage to the corporation.111

However, as stated earlier, the oppression remedy gives the court broad discretion to award “any interim or final order it thinks fit, including ... an order compensating an aggrieved person.”112 The defendant does not need to have made a profit from the oppression113 and directors can be held personally liable.114 Further, the CBCA specifies a compensatory award, which courts have granted in both tort and contract measures both as a means of returning the plaintiff to the place it occupied before the

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110 Drabkin, supra note 34 at 13.
111 See ibid., citing Chase Bank, supra note 109; Phil C. Appenzeller, Jr. & Ross H. Parker, “Deepening Insolvency Part I: A Challenging New Theory or Just the Search for a Deeper Pocket?” (Paper presented at the T.M.A. 2005 Spring Conference, 9–12 March 2005) at 18-19 [unpublished, on file with author]. In Bookland of Maine v. Baker, Newman & Noyes, LLC the court instructed the jury to grant damages for the legal and administrative costs sustained in the bankruptcy proceedings, and for the loss in value to the company up until the date it filed for bankruptcy that the jury could attribute to the defendant (271 F. Supp. 2d 324 at 326 (D. Me. 2002). The “loss in value” proved to be difficult and when the jury made an award, the court found it to be based on erroneous principles and ordered a new trial on damages.
112 CBCA, supra note 3, s. 241(3)(j).
114 Danylchuk, supra note 85 at para. 22.
damage occurred\textsuperscript{115} and as a way to account for the plaintiff’s expectation interest.\textsuperscript{116} Courts have also suggested that punitive damages can be awarded for deterrence purposes.\textsuperscript{117} In any event, seeking to implement a compensatory damage award where the defendant has continued to operate an insolvent company likely involves the same type of calculation employed by American courts—dissipated assets and increased debt load, as well as legal and administrative costs, must all be determined.

3. Conclusion on Oppression Remedy

The oppression remedy, as it exists, is capable of addressing the harm targeted by the deepening insolvency doctrine in the United States. While the interpretation proposed above may require courts to expand their understanding and application of the statutory oppression remedy, doing so would provide the benefit of developing the oppression remedy to deal with these situations, as opposed to stifling its development by importing a narrower and ill-defined doctrine from the United States. Importation of the deepening insolvency doctrine would require Canadian directors to engage in the difficult task of considering two similar, but not identical, doctrines alongside one another when carrying out their duties. This would inevitably raise concerns about the overlap and divergence between the doctrines. Canada’s familiarity with the oppression remedy, and the fact that it has already been designated by the Supreme Court of Canada as appropriate for dealing with situations in which the corporation is in the vicinity of insolvency, point to the benefits of expanding its use rather than bringing in the deepening insolvency doctrine.

A. Claim for Breach of Duty: Another Functionally Equivalent Canadian Doctrine

The deepening insolvency doctrine may be rendered extraneous by yet another Canadian legal principle. In Canada and the United States, officers and directors are fiduciaries to the corporation.\textsuperscript{118} Indeed, in the United States, several claims have treated the doctrine of deepening insolvency as a breach of fiduciary duty,

maintaining that the defendants breached their fiduciary duties to the corporation by wrongfully prolonging its life. Classifying claims in this way begs the question of the necessity of the deepening insolvency doctrine at all. However, regardless of the position taken in the United States, the deepening insolvency doctrine may be unnecessary in Canada due to the existing statutory fiduciary duties and duties of care of Canadian directors.

The deepening insolvency doctrine targets harm to the corporation. The most similar Canadian doctrine would therefore be the fiduciary duty owed to the corporation. Under paragraph 122(1)(a) of the CBCA, directors have a fiduciary duty, sometimes known as the duty of loyalty, to act honestly and in good faith with a view to the corporation’s best interests. By virtue of this duty, directors must be loyal to the corporation and put its interests before their own. The duty is specifically to the corporation; directors, in acting in the best interests of the corporation, can acknowledge the general existence of other interests, including those of employees, shareholders, creditors, and the community, but that does not detract from the fact that directors owe their fiduciary duties to the corporation at all times, even when it approaches insolvency or becomes insolvent.

In Peoples, the Supreme Court of Canada confirmed that a director’s statutory duty of loyalty to the corporation does not extend to creditors, and does not change to encompass creditors when the corporation is approaching the realm of insolvency. In addition, even if the directors do not manage to save the corporation, acting honestly and in good faith precludes them from breaching their statutory fiduciary duty. The Court held:

The various shifts in interests that naturally occur as a corporation’s fortunes rise and fall do not, however, affect the content of the fiduciary duty under s. 122(1)(a) of the CBCA. At all times, directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders.

The directors’ fiduciary duty does not change when a corporation is in the nebulous “vicinity of insolvency”. That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation’s financial stability. In assessing the actions of directors it is evident that any honest and good faith

119 See Rahl v. Bande, supra note 33; Sharp v. Hawkins, supra note 33; Re RSL COM, supra note 33; and Global Service, supra note 52.
120 Thomson, supra note 93 at 32.
122 Peoples, ibid. at paras. 46, 67; Air Canada Pilots Assn. v. Air Canada Ace Aviation Holdings Inc. (2007), 26 B.L.R. (4th) 124 at para. 86, 57 C.C.P.B. 204 (Ont. Sup. Ct.).
attempt to redress the corporation’s financial problems will, if successful, both
retain value for shareholders and improve the position of creditors. If
unsuccessful, it will not qualify as a breach of the statutory fiduciary duty.123

As fiduciaries to the corporation, directors occupy positions of trust, confidence, and
loyalty to the corporation. Since the obligations to act in the best interest of the
corporation require directors to refrain from harming the corporation, their fiduciary
duties would not impose a duty on directors to disclose information on the financial
condition of the corporation to creditors.

This duty would, however, preclude directors from harming the corporation by
wrongfully prolonging its life through the incurrence of additional debt, or by
dissipating remaining corporate assets when the corporation is insolvent and has no
prospect of being able to meet its liabilities. An action for breach of fiduciary duty
arising from the incurrence of additional debt could conceivably be brought even
without a finding of dishonesty or fraud, since “improper purpose” could be broad
enough to encompass the wrongful prolongation of the corporation’s life. It would
therefore be feasible for a derivative action for breach of fiduciary duty to be brought
on behalf of the corporation against the directors for having depleted its remaining
assets while insolvent.124

In addition to this fiduciary duty, every director and every officer has a duty to
“exercise the care, diligence and skill that a reasonably prudent person would exercise
in comparable circumstances” pursuant to paragraph 122(1)(b) of the
CBCA,
generally referred to as the “duty of care”. The standard for this duty is objective, so
the factual circumstances surrounding the directors’ actions are important.125 The
Supreme Court of Canada in Peoples noted that since the statute is open-ended,
creditors must be capable of being included amongst the beneficiaries of this duty.126
However, in order to succeed in showing a violation of this duty, the plaintiff must
show both a breach of the duty of care and a consequent harm to the plaintiff. A
breach will not be found if the directors acted prudently and on an informed basis.127
In Peoples, the unsuccessful but good-faith attempts to “rescue” a corporation on the
verge of insolvency did not constitute a violation of directors’ duties to the creditors.

In summary, acceptance of the proposition that wrongfully prolonging the
corporation’s life is harmful to the corporation means this occurrence can be used to
constitute a claim for breach of fiduciary duty. In addition, a claim for breach of duty

123 Peoples, ibid. at paras. 43, 46 [emphasis added].
124 See generally CBCA, supra note 3, s. 239; OBCA, supra note 79, s. 246 (stating that a derivative
claim can be brought against directors on behalf of the corporation).
125 Peoples, supra note 1 at para. 63.
126 Ibid. at para. 57.
127 Ibid. at paras. 66, 67; Axton Industries Ltd. v. Bobbiduncan Holdings Ltd. (2006), 151 A.C.W.S.
(3d) 839 at paras. 168-70 (B.C.S.C.). The breadth of the duty of care is confined by the business
judgment rule. For an explanation of the business judgment rule, see Part III.
of care might also be possible if it can be proven that directors were not acting on a reasonably informed basis.

B. Claim for Negligent or Fraudulent Misrepresentation: Similar but not Identical

It is a well-known common law principle that when a party induces another to enter into a contract by making careless statements, or statements which the former knows to be false, the innocent party may have a claim for negligent or fraudulent misrepresentation. While claims for misrepresentation could encompass claims in which creditors extend money or provide supplies to the debtor corporation based on certain misrepresentations about the corporation’s financial status and its ability to repay creditors, an essential distinction between misrepresentation and deepening insolvency lies in the availability and potential consequences of each. An action for misrepresentation would only be available to the creditor to whom the misrepresentation was made for the harm done to that particular creditor. If the action is successful, funds would be restored to that creditor. While a claim for deepening insolvency may arise under similar facts, it is brought by the corporation, or by all creditors on behalf of the corporation, for harm done to the corporation. A successful deepening insolvency action brings money back into the corporation, which then benefits all creditors on disbursement. Therefore, while a claim for misrepresentation cannot act as a replacement for the deepening insolvency doctrine, an individual creditor might pursue it in conjunction with a claim for breach of fiduciary duty or the oppression remedy.

An independent cause of action must be established against corporate officers in order to find them personally liable for misrepresentation.\(^\text{128}\) As a general rule, directors and officers are exposed to personal liability for acts committed in the course of their employment,\(^\text{129}\) with the exception in *Said v. Butt*, which held that directors and officers are not liable for inducing a breach of contract between the corporation and a third party.\(^\text{130}\) While the principles appear uncomplicated at first glance, a deeper look reveals that courts have been inconsistent in the development of the law on directors’ personal liabilities in tort. In general, it is possible to sue a


\(^{130}\) *Said v. Butt*, supra note 128. For an explanation of *Said v. Butt*, see Nicholls, * supra* note 36 at 8-9; Janis Sarra, “The Corporate Veil Lifted: Director and Officer Liability to Third Parties” (2001) 35 Can. Bus. L.J. 55 at 59 [*Sarra, “Director and Officer Liability”*]. Sarra maintains that the exception of the tort of inducing breach of contract exists because (1) it ensures others who deal with the corporation will not have available to them actions for both breach of contract and personal tort claims against the directors, and (2) it ensures minimal interference with directors’ decisions to terminate the corporation’s contracts (*ibid.*). See also *ADGA Systems*, supra note 128 at 105-06.
director personally if the act complained of is not attributable to the corporation but rather is an action separately belonging to the individual director. From that rule, two lines of cases have emerged. One line, beginning with *ScotiaMcLeod Inc. v. Peoples Jewellers Ltd.*, maintains that, absent fraud or deceit, directors acting within their duties will rarely be held personally liable in tort to third parties for actions they commit through their corporations. As Janis Sarra has pointed out, directors would therefore be able to avoid personal liability if their tortious conduct was committed in the best interests of the corporation.

The other, more recent line of cases has interpreted *ScotiaMcLeod* more broadly, and articulated a more expansive realm within which tortious conduct can be the subject of liability. In *ADGA Systems International Ltd. v. Valcom Ltd.*, the Court of Appeal for Ontario determined that corporate officers should be held liable for torts they commit, even if the commission was in good faith and in the best interests of the corporation, with the exception of the situation covered by *Said v. Butt*. The court has gone on to uphold this slightly broader approach in subsequent decisions, leading to the conclusion that directors and officers may be found personally liable for torts they commit, even when acting in the course of duty and in the best interests of the corporation. Note that any fraudulent action taken by a director to increase corporate profits is not considered to be in the bona fide interests of the corporation.

Canadian jurisprudence has therefore developed a body of law capable of dealing with the tortious conduct of directors. Involvement in fraudulent misrepresentation will leave these individuals open to personal liability for their tortious acts, and any tortious act that does not meet the threshold for fraud may leave them open to liability under the principles articulated in *ADGA Systems*. Provided a duty of care to the plaintiff can be found, a necessary element in the maintenance of a tort action in common law provinces, there is no bar to bringing a tort claim against corporate

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134 “Director and Officer Liability”, supra note 130 at 64, 66. This doctrine was subsequently confirmed in *Normart Management Ltd. v. West Hill Redevelopment Co.* ((1998), 37 O.R. (3d) 97, 155 D.L.R. (4th) 627 (C.A.)) and in *Alper Development* (ibid.).
135 *Supra* note 128 at 111-14.
officers. While Canadian courts have not yet found a common law duty of disclosure resting on directors, it is possible for a duty of care to arise if the situation lends itself to a factual finding of negligent misrepresentation.

To hold a director personally liable for misrepresentation, a duty must be found between the creditor and the director. In *NBD Bank*, a case containing a detailed analysis of the development of the duty of care, a corporate officer was found personally liable for misrepresenting corporate information to a creditor at a time the corporation was nearly insolvent in order to secure a loan from the plaintiff bank. 139 Two weeks after the loan extension, the corporation announced its insolvency. In a claim brought by the bank against the officer, the court found the officer personally liable for having misrepresented the financial information. Justice Rosenberg found that a duty of care existed between the director and the corporation by relying on *Hercules Management Ltd. v. Ernst & Young*,140 which, in turn, relied on Justice Wilson’s summary of the Anns test141 in *Kamloops (City of) v. Nielsen*:142

(1) is there a sufficiently close relationship between the parties (the [defendant] and the person who has suffered the damage) so that, in the reasonable contemplation of the [defendant], carelessness on its part might cause damage to that person? If so,

(2) are there any considerations which ought to negative or limit (a) the scope of the duty and (b) the class of persons to whom it is owed or (c) the damages to which a breach of it may give rise?143

Therefore, in order for a duty of care to exist between the parties, a proximate relationship must first be established—a relationship that “arises through reliance by the plaintiff on the defendant’s words.”144 Such a relationship is easily found between a corporate officer who makes decisions on behalf of the corporation and who relays information to a creditor, and the creditor who subsequently relies on this information to extend a loan to the corporation. In *NBD Bank*, the court found that the corporate officer “ought reasonably to have foreseen that the respondent would rely upon his representations,” and accordingly, that such reliance was reasonable.145

With regard to the second part of the Anns test, which contemplates whether policy considerations should preclude the court from finding a duty in the circumstances, Justice Rosenberg refrained from finding a “blanket duty” and instead noted that the circumstances of each case will determine whether a duty arises.146 In addition, he failed to see how the imposition of liability on directors for negligent

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139 *Supra* note 137.
143 *Ibid*. at 10-11; *NBD Bank, supra* 137 at para. 45.
144 *Hercules, supra* note 140 at para. 24.
145 *NBD Bank, supra* note 137 at para. 48.
misstatements made prior to the company’s insolvency would be problematic, and found that “it would be contrary to good policy to immunize officers from the consequences of their negligent statements which might otherwise be made in anticipation of being forgiven under a subsequent corporate proposal or arrangement.”147 Finally, with regard to the potential for indeterminate liability, a “fundamental policy consideration”,148 Justice Rosenberg quoted Justice La Forest, who, writing for the court in Hercules, had noted that the extent of liability is sufficiently constrained by the requirements that the defendant make the statement to the plaintiff and that the statement be used for the purpose for which it was intended.149

While NBD Bank dealt with negligent misrepresentation, the higher threshold of fraudulent misrepresentation would be met by proving that the corporate officer, knowing the information he was conveying to be untrue, acted with an intention to deceive the party relying on the misrepresentation. In fact, several cases have reached similar findings, as courts have been leaning in that direction for years. In Hall-Chem Inc. v. Vulcan Packaging Inc.,150 it was suggested that directors who engage in fraudulent behaviour take on an identity separate from the corporation’s and should be held personally liable for the harm inflicted.151 The director in Re Traders Trust and Kory was found liable for fraudulent misrepresentation when the money he had acquired to fund a mortgage investment was subsequently used to pay the company’s debts.152 In TCT Logistics, the court intimated that a creditor who is misled by the corporation with regard to the latter’s financial situation would be able to hold a director personally liable if the director was aware of the misrepresentation.153

A claim for negligent or fraudulent misrepresentation cannot act as a replacement for the deepening insolvency doctrine, but it could be pursued in conjunction with a claim for breach of fiduciary duty, or a claim under the oppression remedy. While there is no common law duty of disclosure for directors, the courts have determined that in certain circumstances, a duty of care can arise between directors who misrepresent the financial condition of the corporation and the parties who rely on the misstatement.

147 Ibid. at para. 54.
148 Hercules, supra note 140 at para. 31.
149 Supra note 145 at para. 59.
151 Pinsky & Bybelezer, supra note 131 at 402.
Conclusion

While much about deepening insolvency has yet to be settled in the United States, questions about the doctrine’s applicability and functionality in Canada are presently at the forefront of Canadian commercial law. The principle of holding directors and third parties liable for wrongfully prolonging a corporation’s life is appealing on an intuitive level and seems to come with many advantages. Indeed, the benefit to creditors of the deepening insolvency doctrine is indisputable: the successful pursuit of directors and third parties in a deepening insolvency action allows for money to brought into the corporate debtor’s estate to repay creditors. However, before the legal profession gets carried away with the idea of importing this U.S. doctrine into Canada, it is important to look to the remedies in Canadian law that may already address those harms. As this analysis has indicated, the statutory oppression remedy is capable of addressing the harm sought to be addressed by the deepening insolvency doctrine. While the interpretation proposed above may require courts to expand their understanding and application of the oppression remedy, doing so would allow Canadians to develop an existing remedy rather than import an ill-defined doctrine from the United States. Therefore, before Canadians become as enamoured with deepening insolvency as U.S. courts have been in recent years, examining the current state of Canadian law will necessarily lead to the conclusion that importing the deepening insolvency doctrine into Canada is not necessary.