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• MEGA BRANDS INC.: THE CANADA BUSINESS CORPORATIONS ACT PROVIDES AN INNOVATIVE APPROACH TO BALANCE SHEET RESTRUCTURING AND A LANDMARK RESULT •

Ward A. Sellers, Sandra Abitan and Audrey DeMarsico
Osler, Hoskin & Harcourt LLP

On March 22, 2010, the Superior Court of Quebec approved a plan of arrangement under the *Canada Business Corporations Act* [CBCA], R.S.C. 1985, c. C-44, that allowed a corporation, MEGA Brands Inc., to achieve a worldwide restructuring of its business under a corporate statute, rather than a more typical insolvency and restructuring statute like the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36.

The arrangement compromised the claims of secured lenders under a credit agreement and two swap agreements as well as the claims of convertible debenture holders. The arrangement also effected a significant dilution of shareholders, but preserved an equity stake in the continuing company for these shareholders. The Court granted a temporary stay of proceedings against the applicant corporations as well as impleaded parties in the United States, Europe, and Mexico.

On March 23, 2010, the United States Bankruptcy Court for the District of Delaware granted an order enforcing the arrangement in the United States, under Chapter 15 of the *U.S. Bankruptcy Code*.

These orders confirm that the CBCA arrangement provision can provide a practical option for a quick and effective restructuring of a company's debt securities where stakeholders support the outcome and the Court is able to conclude that the transaction is fair and reasonable. This result was of critical importance to MEGA Brands, given that it operates in the toy industry and its concern that proceeding under an alternative statutory framework such as the *Companies' Creditors Arrangement Act* and Chapter 11 under the *U.S. Bankruptcy Code*, could result in substantial harm to its relations with suppliers and customers, and substantial erosion of value to the business and stakeholder interests.

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It is the first time an arrangement of this nature has been implemented in Canada. Although certain companies, such as Abitibi-Consolidated Inc., have previously tried to restructure under the *CBCA*, they have not been able to successfully complete their restructuring under this corporate statute as MEGA Brands managed to do.

BACKGROUND

MEGA Brands is a corporation governed by the *CBCA*, with its head office and senior management in Montreal. The arrangement involved a transaction between MEGA Brands and a number of related corporations and direct and indirect subsidiaries in Canada, the United States, Luxembourg, and Mexico.

Shareholders and lenders voted overwhelmingly in favour of the arrangement.

THE DECISIONS

CANADA

In written reasons for issuing the interim order, Justice Castonguay confirmed that restructuring debt is an appropriate use of the *CBCA* arrangement provision. He based this decision on a small line of precedents involving the companies Tembec Arrangement Inc., Trizec Corporation Ltd., and Abitibi-Consolidated Inc. In the case of MEGA Brands, this included secured bank debt outstanding under a credit agreement with a number of banks and other lenders, secured debt under two swap agreements and unsecured notes issued under a trust indenture.

To be able to avail itself of the *CBCA* arrangement provisions, a corporation must be able to demonstrate both that it is not insolvent and that it is impracticable for the corporation to effect a fundamental change in the nature of an arrangement under any other provision of the Act. Justice Castonguay found that MEGA Brands met the first of these requirements because at least two of the applicant corporations were solvent and because MEGA Brands continued to meet its obligations as they became due and would become solvent upon completion of the transaction. He also found that it was not practicable to proceed other than by way of arrangement when viewing the transaction as a complete package, in part because the arrangement contemplated the issuing of new shares by a company subject to American law. In reaching this conclusion, he preferred the English version of the arrangement provision over

the French, which would translate literally to “practically impossible” rather than “not practicable.” He found that the Policy Statement of Industry Canada concerning *CBCA* arrangements was consistent with the more permissive language in the English version. With respect to the stay of proceedings, he noted that MEGA Brands was party to a number of contracts that could be interpreted to stipulate events of default if MEGA Brands availed itself of the *CBCA* arrangement provision. He noted that the objectives of the arrangement were legitimate and contemplated by the statute and that the stay of proceedings was necessary to give effect to these objectives. He also noted that the stay was temporary and would only affect a limited number of creditors. For these reasons, he granted a stay of proceedings relating to any default as a result of the arrangement until the hearing of the application for a final order approving the arrangement.

Justice Gascon did not issue reasons in conjunction with his final order approving the arrangement. He did, however, write a preamble to the order noting that the arrangement was fair and reasonable. In the final order itself, he gave effect to the mutual releases and discharges contemplated in the plan of arrangement and declared that the applicants and impleaded parties were authorized to take all steps and actions necessary or appropriate to implement the arrangement and the transactions contemplated thereby. He also granted a stay of proceedings relating to the arrangement until the earlier of May 15, 2010 or the date at which the arrangement was fully implemented. He declined to grant a permanent stay of proceedings such as Justice Pepall granted in the *Tembec* arrangement.

UNITED STATES

In the U.S. proceeding, Justice Sontchi granted an order recognizing the Canadian proceeding under Chapter 15 of the *U.S. Bankruptcy Code*.

Specifically, he found that the Canadian arrangement proceeding was a “foreign main proceeding” for the Canadian entities involved and that it was a “foreign nonmain proceeding” for the U.S. entities involved in the arrangement for purposes of §§ 1515 and 1517 of the *U.S. Bankruptcy Code*. He also recognized MEGA Brands’ Chief Financial Officer as the foreign representative of the entities involved in the arrangement pursuant to § 101(24) of the *Bankruptcy Code*. Finally, he granted an or-

der giving full force and effect to the arrangement in the United States.

In particular, Sontchi J. gave effect to the mutual releases and discharges contemplated in the plan of arrangement; authorized the entities involved in the Canadian proceeding to take actions in the U.S. necessary or appropriate to implement the Arrangement and the transactions contemplated thereby; and gave effect to the stay of proceedings contemplated in the order of Gascon J. He also authorized the foreign representative to take all actions necessary to effectuate the relief granted in the U.S. order.

IMPLICATIONS

The orders described above confirm that the arrangement provision provided in s. 192 of the *CBCA* can be an effective mechanism for a company to restructure its debt securities by exchanging them for cash, equity, new debt, or a combination thereof.

Unlike the *CCAA*, the *CBCA* allows the arranged entities to remain in control of the restructuring process and does not call for a trustee or court-appointed monitor to oversee the transaction. Thus, in circumstances where compromising trade creditors is not an important aspect of the restructuring, a *CBCA* arrangement may provide a more efficient and flexible alternative for corporations that choose to restructure debt. In addition, the *CBCA* process is faster and less costly than the *CCAA*, and there may be a business benefit to not undertaking insolvency proceedings.

At the same time, it remains an open question as to the scope of circumstances in which the Court will endorse the *CBCA* as an appropriate statutory framework for balance sheet restructuring, particularly where secured bank debt, non-*CBCA* companies or broad stays of proceedings are involved.

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• ADVISING DIRECTORS OF COMPANIES THAT ARE INSOLVENT OR IN THE ZONE OF INSOLVENCY •

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INTRODUCTION

The saying goes that when the United States sneezes, Canada gets a cold. Accordingly, when the most recent economic recession hit the United States, the financial health of many Canadian companies predictably suffered.

Advising directors of companies that are either insolvent or in the zone of insolvency regarding the scope of their personal liability can be an enormously daunting task as directors can be exposed to significant personal liability in a variety of areas of the law. Directors are now accountable not only to the corporation and its shareholders but also under certain circumstances to employees, creditors, customers, suppliers, and governments. The purpose of this article is to provide overview of the legal duties of directors and the personal liability that can be imposed and to discuss ways in which exposure to liability can be managed. It is not intended to provide legal advice to directors, or to be a comprehensive review of all of the duties and liabilities of directors.

LEGAL DUTIES OF DIRECTORS

Directors are responsible for managing, or supervising the management of the business and affairs of the corporation.¹ In discharging this duty, the common law and corporate statutes impose two prevailing duties on a director to: (i) act honestly and in good faith with a view to the best interests of the corporation; and (ii) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances. Both duties were developed at common law but have since been codified in federal (*Canada Business Corporations Act* [CBCA])² and provincial business statutes such as the Ontario *Business Corporations Act* [OBCA].³

Directors are considered "fiduciaries" of the corporations they serve. This principle requires directors to act honestly and in good faith with a view to

the best interests of the corporation. The fiduciary role involves several concomitant duties, including:

- The duty to avoid conflicts of interest;
- The duty not to use his or her position for personal gain;
- The duty to maintain the confidentiality of the corporation's information;
- The duty to serve the corporation selflessly, honestly, and loyally; and
- The duty to exercise independent judgment.⁴

Directors are also required to provide a minimum standard of care in carrying out their responsibilities. This minimum standard is generally described in the corporate statutes as exercising "the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances". The wording of these business statutes has upgraded the standard of care from the previous common law standard of gross negligence to simple negligence. In the 2004 *Peoples Department Store v. Wise*⁵ [*Peoples*] case, the Supreme Court of Canada confirmed that the appropriate test requires directors to be judged by the purely objective standard of a reasonably prudent person rather than a mixed objective/subjective standard in which personal attributes are to be taken into account.⁶

It should be noted that the wording of this standard is not the same in every province and that many provincial corporate statutes do not define the minimum standard of care at all. In these provinces, the minimum standard is governed by the common law, which requires that a director exhibit the degree of care and skill that might be expected of a person with the knowledge and experience of the director in question. Courts generally apply the "business judgment rule" in evaluating whether the minimum standard has been applied. The rule protects direc-

tors from second-guessing by the courts and ensures that directors are held to a standard of reasonableness, not perfection.⁷

COMMON LAW DUTIES TO CREDITORS

Directors only owe a fiduciary duty to the corporation. This duty of loyalty does not change when a corporation is in the “vicinity of insolvency”.⁸ However, contrary to the fiduciary obligation, when a company is insolvent or nearly so, a director may owe a duty of care to a variety of new stakeholders, including the company’s creditors.

The Supreme Court of Canada in *Peoples* addressed the issue of directors’ duties to creditors. In that case the Superior Court awarded a judgment in excess of \$4 million against the directors of Peoples Department Stores on the grounds that the directors had failed to satisfy their statutory duties under s. 122 of the *CBCA* by failing to foresee the detrimental impact of adopting a particular inventory policy. The Supreme Court stated that the “best interests of the corporation should be read not simply as the best interests of the shareholders” and enunciated:

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.⁹

That said, the Supreme Court of Canada stated that directors of a corporation do not owe independently enforceable fiduciary duties to the corporation’s creditors even if the corporation is insolvent or near-insolvent. However, the Court did indicate that in such circumstances directors are likely to have an obligation to consider the interests of creditors in fulfilling their statutory duties to the corporation. Where a director fails to consider the creditors’ interests, creditors may seek to obtain leave to commence a derivative action in the name of the corporation or proceed by way of the oppression remedy.

In *Peoples*, the Supreme Court of Canada indicated that it will respect the reasonable business judgment of directors who act honestly and in good faith, who attempt to obtain and consider the relevant information and alternative courses of action, and who consider the interests of the different stake-

holders of the corporation, even if the end result of those efforts is unsuccessful. The Court went on to state that while the courts should be reluctant to second-guess the business decisions made by directors, the courts are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision.

NEW TRENDS — *BCE* CASE

In 2008, the Supreme Court of Canada (“SCC”) rendered its decision in *BCE Inc v. A Group of 1976 Debentureholders, et al.*¹⁰ with respect to the largest leveraged buyout in Canadian history. In the case, the board of directors of BCE Inc. approved a proposal whereby the Ontario Teachers’ Pension Plan and its partners Providence Equity Partners Inc., Madison Dearborn Partners, LLC, and Merrill Lynch Global Private Equity would acquire all the outstanding shares of BCE at a price of C\$42.75 per common share, a 40 per cent premium for BCE’s common shareholders. The SCC ruled that the buyout, which was to be effected by way of a plan of arrangement under s. 192 of the *CBCA*, could proceed. In reversing the Quebec Court of Appeal decision, the SCC held that as long as the directors acted in the best interests of the corporation, having regard to all relevant considerations (including, but not limited to, the need to treat affected stakeholders fairly), where it is impossible to treat all stakeholders fairly, it is irrelevant that the directors chose a less favourable alternative for one group.

The decision in this case turned on the scope of the BCE directors’ duties in the context of the leveraged buyout. The Court confirmed that while directors of a corporation, when acting in the best interests of the corporation, may be required to consider the impact of their decisions on other corporate stakeholders, the directors’ fiduciary duty is limited to the corporation.¹¹ The Court stated that in cases where the interests of the corporation and various stakeholders do not coincide, the reasonable expectations of the stakeholders can only be that the directors act in the best interest of the corporation.

DIRECTORS’ LIABILITIES

PERSONAL LIABILITY FOR OBLIGATIONS OF CORPORATION

There are a number of liabilities imposed upon directors personally for the obligations of the corpora-

tion under various federal and provincial statutes. Directors should also keep in mind that they may be liable for any acts or omissions of the board of directors carried out in their absence since they are deemed to have consented unless they register their dissent according to the procedures set out in the governing corporate statute.¹² The following are examples of potential liabilities and is not intended on being an exhaustive list.

(A) *EMPLOYEE WAGES*

Under s. 131 of the *OBCA*, a director will only be liable for the unpaid wages if the services performed by the employee were carried out while he or she was a director. Liability also extends to up to 12 months of unpaid vacation pay accrued while he or she was a director. However, the *OBCA* limits this liability to, for example, situations where the corporation has also been successfully sued and the execution for judgment against the company is returned unsatisfied. Section 119 of the *CBCA* sets out the same liability and with similar limitations. In particular, a director is only liable if, among other things, the director is sued while he or she is a director or within two years after ceasing to be one.

Practically, this liability will be relevant only where the corporation is insolvent, as a director will become personally liable only where the recovery of the amounts from the corporation is impossible or unlikely. While under the *OBCA* directors are strictly liable for these amounts, under the *CBCA*, directors will be relieved from liability if they rely in good faith on the financial statements of the corporation that are represented by an officer or in a written report of the auditor to fairly reflect the financial condition of the corporation, or where he or she relies on a report of a professional advisor.¹³ This is known as the “due diligence defence”. The due diligence defence is not available in respect of employee wages under the *OBCA*.

There is uncertainty under Ontario law with respect to the extent of a director’s personal liability for unpaid wages and vacation pay. It is unclear if liability extends to those amounts that have accrued while the individual is a director, or if liability is restricted to those amounts that actually became payable to employees during the director’s tenure. The distinction is an important one because if the liability is only for amounts that are “payable”, it may be possible to avoid such liability by resigna-

tion as a director prior to the date of employee termination (which would give rise to the accrued amounts becoming payable).

The issue appears to be more settled in the Western provinces where courts have held that directors are liable for unpaid wages and vacation pay that accrue during their tenure. This was found to be the case even if the director resigned prior to the termination of the employee(s) (see *Brown v. Shearer*,¹⁴ and *Bell v. British Columbia Director of Employment Standards*).¹⁵ Contrary to this position, before 2005, courts in Ontario held that a director who resigns before the termination of employees is not personally liable for the unpaid wages and vacation pay owing to those employees. The reasoning of the Court appears to be that since no debts are “payable” to employees at the time the individual was a director there can be no corresponding liability to the director.¹⁶

However in March of 2005, the Ontario Superior Court of Justice (the “Ontario Court”) released its decision in *Englefield v. Wolf [Englefield]*.¹⁷ On behalf of all former employees of Dylex, Englefield brought a motion for default judgment against Wolf, who became a director of Dylex three months prior to the employees’ termination.

The Court specifically rejected *Vopni* and instead, chose to follow the reasoning from the Western provinces. A director’s liability for unpaid wages and vacation pay was held to accrue during employment and not “crystallize” only upon the employees’ termination. The Court held that the fact that Wolf was a director when the employees of Dylex were terminated did not make him liable for all unpaid wages and vacation pay. Instead, the extent of Wolf’s liability was restricted to the limited amount of unpaid wages and vacation pay that had accrued during the period for which he served as a director on the Dylex board.

This decision appeared to bring Ontario law into line with the Western provinces. However, the facts of the case were not such that the Court had to determine the issue of whether liability would terminate by reason of resignation prior to the date the vacation pay was payable since Wolf was a director when the employees were actually terminated.

A year later the Ontario Court considered the director liability sections of the *Employment Standards Act [ESA]*¹⁸ in *Warehouse Drug Store Ltd. (Re) [Warehouse]*.¹⁹ Neither *Englefield* nor *Vopni* were explicitly considered by the Court.

In *Warehouse*, the Ontario Court considered director liability in the context of insolvency proceedings under the *Companies' Creditors Arrangement Act*.²⁰ The employees of the insolvent company had been transferred to a new corporation and that corporation was deemed a successor employer. A directors' and officers' charge had been established by Court Order and a former director had filed a claim for indemnity. The director attempted to claim for amounts owing for employee vacation pay that he would be liable for if the new corporation failed to pay the amounts owing for vacation pay.

Contrary to the decision in *Englefield* where the Court held that a director is personally liable for amounts accrued while the director is in office, in *Warehouse*, the Court held that a director is only liable for amounts which are due and payable while he or she is a director of the corporation. The director's claim was denied due to the fact that there were no unpaid wages or vacation pay due and payable while he was a director.

The decision in *Warehouse* appears to provide support for the *Vopni* reasoning of directors' and officers' liability for unpaid wages and vacation pay.

(B) *LIABILITY UNDER
EMPLOYMENT STANDARDS LEGISLATION*

Provincial employment standards legislation also imposes personal liability on directors. The extent of director liability varies by provincial jurisdiction, as the obligations of directors are based in statutes enacted in each of Canada's provinces and territories. This liability generally arises from the failure of a corporation to make the proper payments to its employees, often in a receivership or insolvency situation. For example, the Ontario *Employment Standards Act, 2000*²¹ provides that directors are jointly and severally liable for claims of unpaid wages that have been filed with a receiver or trustee-in-bankruptcy of an insolvent company and have not been paid. Under the various provincial employment standards legislation, the fact that a director has exercised due care will not prevent a court from imposing personal liability.

(C) *EMPLOYEE PENSION PLAN*²²

While Canada does not oblige corporations to establish registered pension plans for its employees, if the corporation decides to do so, directors will have responsibilities to either the corporation (when the

board is acting as the plan sponsor) or to the members and beneficiaries of the pension plan (when the board is acting as the plan's administrator).²³

If a corporation is found guilty of an offence under the relevant pension legislation, its directors may be criminally charged if they directed, authorized, assented to, acquiesced in, or participated in the contravention of the relevant statute by the corporation. Depending on in which province the offence occurs, a director that is found guilty of such an offence can be liable for a fine up to \$100,000, 12 months imprisonment, or both for a first offence.²⁴ Personal liability may also arise where the corporation has been convicted of an offence related to a failure to make payment or remit payment.

Due to the oversight required to properly administer a pension plan, in practice, directors are not expected to undertake the day-to-day administration and investment of the pension plan. In recognition of the required time and expertise, the board — as the administrator — have either implicit or explicit²⁵ powers to delegate the administrative function to agents. The directors are responsible for selecting suitable agents and for prudently and reasonably supervising such agents. However, this delegation of administration by the board does not absolve it of its legal responsibilities as administrator of the pension plan.²⁶

(D) *EMPLOYEE SOURCE DEDUCTIONS AND
EMPLOYER PREMIUMS*

(i) *Income Tax*

The federal *Income Tax Act*²⁷ requires a corporation to deduct or withhold certain amounts from payments such as salary and benefits and to remit those amounts to the government. If the corporation fails to do so, then its directors are jointly and severally liable to pay the amount(s) and any related interest or penalties.²⁸ In addition to amounts relating to employees, directors are also liable if the corporation fails to deduct, withhold, or remit patronage dividends or amounts such as rents, royalties, interests, and dividends paid to a non-resident of Canada that are subject to withholding tax. A due diligence defence is available to directors that will relieve them from liability where they exercise the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have in comparable circumstances.²⁹

(ii) Employment Insurance

Under the *Employment Insurance Act [EIA]*,³⁰ an employer must deduct the prescribed amounts from remuneration paid to employees and remit that amount to the government, together with the employer's premium. If a corporate employer fails to do so, the directors at the time of the failure are jointly and severally liable for those amounts together with interest and penalties.³¹ The *EIA* also imposes joint and several liabilities on directors for a number of matters relating generally to information provided to the Canadian Employment Insurance Commission, such as knowingly providing false or misleading information to the Commission in relation to an employee's claim for benefits.³² A due diligence defence is available where the director exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances.³³

(iii) Canada Pension Plan

Under the *Canada Pension Plan ("CPP")*,³⁴ an employer must deduct the prescribed amount from remuneration paid to employees and must remit that amount to the government, together with the employer's contribution. Directors are jointly and severally liable for employee and employer CPP contributions which the corporation fails to remit.³⁵

Liability for (i), (ii) and (iii) only extends to those directors who were directors at the time the corporation was required to make the remittances. Canada Revenue Agency ("CRA") will not be able to recover any amounts from a director if it commenced an action against the director more than two years after that person ceased to be a director. CRA's published position is that a due diligence defence requires directors to take positive steps to ensure that the corporation makes the required remittances. Directors, who have not been actively involved in the affairs of the corporation, face the same risks as directors who have taken an active role in the affairs of the corporation.³⁶

(E) GOODS AND SERVICES TAX ("GST")

Under the *Excise Tax Act*,³⁷ companies which charge GST are required to remit net tax owing to the Receiver General. Individuals who were directors at the time a failure to remit occurred are jointly and severally liable to pay the net tax owing. In this case, the due diligence defence is available to a di-

rector where the director exercised the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

(F) HARMONIZED SALES TAX ("HST")

With the enactment of HST in several Canadian provinces including Ontario as of July 1, 2010, directors now have the same potential liability for a corporation's unremitted net tax (whether or not it was collected) and overpaid net tax refunds (including interest on penalties) as they would for GST.³⁸ However, a former director is not liable for unremitted HST more than two years after ceasing to be a director. The due diligence defence is also available.

(G) OCCUPATIONAL HEALTH AND SAFETY

Both federal and provincial statutes that regulate the health and safety of employees in the workplace impose liability on directors. In all provinces, except Ontario and British Columbia, a director who directs, authorizes, assents to, acquiesces or participates in an offence committed by the corporation under the relevant provincial legislation is guilty of an offence.

In Ontario and British Columbia, personal liability is imposed on directors to ensure the corporation complies with the applicable safety legislation. Failure to take reasonable care to ensure that the corporation complies with any orders of inspectors or other officials may expose directors to prosecution, and upon conviction, to a fine of up to \$25,000, 12 months imprisonment, or both.³⁹ In order for a director to create the basis for a due diligence defence to this potential liability, the board must become involved in the setting of goals, designation of responsibility, allocation of resources, and the strengthening of necessary support mechanisms for corporate health and safety policy pronouncements and programs.⁴⁰ Directors must also be kept apprised of major health and safety issues at the workplace.⁴¹ Failure to act once a director is aware of a problem will limit the potential defence that the directors acted in a diligent fashion. Equally, the failure of directors to take steps to inform themselves of health and safety issues at their workplace, will likely result in directors being unable to prove that they were duly diligent in the performance of their duties as the directing minds of the corporation.

(H) RETAIL SALES TAX

Under certain provincial retail sales tax legislation, a corporate vendor is required to collect and remit sales tax assessed for the provincial government. Directors will be jointly and severally liable for this amount if the corporation fails to pay this tax or if a director authorized or participated in the commission of an act that is an offence under the relevant legislation.⁴² Directors will not be liable unless the corporation is first unable to pay or if the director exercised the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.⁴³

(I) ENVIRONMENTAL

Directors face significant personal exposure under federal and provincial environmental statutes. In general, environmental offences are “strict liability,” which means that directors will need to show that they took reasonable care to prevent the offence from occurring. A due diligence defence may be established if there is proof that the directors took all reasonable steps to: (a) prevent the commission of the offence, and (b) ensure the effective operation of that prevention program.

(J) CRIMINAL CODE

The *Criminal Code*⁴⁴ (Canada) now also makes directors liable for negligent conduct, recklessness, or fraudulent intent. While potential *Criminal Code* prosecutions are not limited to violations of safety or environmental requirements at a workplace, those are the two areas that seem to have attracted the greatest publicity. If a corporation is convicted, directors can face imprisonment for up to six months and a fine of up to \$2,000 for each offence.

(K) BANKRUPTCY AND INSOLVENCY ACT [BIA]⁴⁵

A number of potential liabilities exist under the *BIA*. Directors may be personally liable for the following:

- Dividends or for redeemed shares where payment was made one year preceding bankruptcy and the corporation was insolvent at the time the payment was made, or rendered insolvent as a result of making the payment.⁴⁶
- Bankruptcy offences where the director authorizes, assented to, acquiesced in, or

participated in the commission of the offence.⁴⁷

- An officer or person in control of the corporation is liable if he or she fails to perform the obligations imposed on the bankrupt corporation.⁴⁸
- Where a court determines that any person was privy to a transfer at under value, the court may order that the person pay the difference between the value of consideration given to the debtor and the value of the consideration received by the debtor.⁴⁹

(L) CCAA⁵⁰

The *CCAA* permits the inclusion of compromises of claims against directors that arose before the commencement of *CCAA* proceedings and that relate to the obligations of the company where the directors are liable by law in their capacity as directors.⁵¹ There are, however, a number of exceptions to the provision for the compromise of claims against directors, including claims that: (i) relate to contractual rights of one or more creditors; (ii) are based on allegations of misrepresentation by the directors; and (iii) are based on allegations of oppressive conduct by the directors. The Court may also decide that a claim against a director cannot be compromised where it would not be fair and reasonable in the circumstances.⁵² Courts generally provide a carve out in the compromise of claims against directors which arise on account of gross negligence or wilful misconduct.

Under the recent amendments to the *CCAA*, the transfer at under value provisions found in ss. 38 and 95-101 of the *BIA* are deemed to apply unless the plan of compromise or arrangement specifically excludes them. The *BIA* provides that on application by a trustee (which includes a monitor) a Court may order that a transfer at under value is void as against the trustee or order that a party to the transfer, or any person who is privy to the transfer, pay to the estate the difference between the value received by the debtor and the value given by the debtor.⁵³ It is possible that the transfer at under value provisions of the *BIA* could be used by a court to apportion liability to the director as a person who was privy to the transfer at under value.

(M) *WAGE EARNERS PROTECTION PROGRAM ACT [WEPPA]*⁵⁴

The purpose of *WEPPA* is to provide for the payment of wages⁵⁵ out of the Consolidated Revenue Fund to employees (up to a maximum of the greater of (a) a \$3000 threshold or (b) an amount equal to four times the maximum weekly insurable earnings under the *Employment Insurance Act*), when employees are terminated due to bankruptcy or receivership and those employees were not paid for six months prior to the date of bankruptcy or the appointment of a receiver.⁵⁶ If a payment is made under *WEPPA* in respect of unpaid wages, the Government of Canada is subrogated to the rights of those employees to the extent of the amount of the payment as against the insolvent corporation. *WEPPA* also gives the Government of Canada the right to use labour and employment statutes to assume the rights of the unpaid employees against the directors of the insolvent corporation.⁵⁷

PERSONAL LIABILITY WHERE CORPORATION MAY NOT BE LIABLE

There are also circumstances where directors could incur personal liability where the corporation itself might not be liable. There are various remedies available to enforce directors' liabilities under the *CBCA* or the *OBCA* such as: (a) Oppression Remedy; and (b) Derivative Action.

(A) *OPPRESSION REMEDY*

The *OBCA* and the *CBCA* provide remedial relief to a wide group of complainants, including creditors, in circumstances where their interests have been oppressed or unfairly prejudiced or disregarded by the corporation.⁵⁸ While an appreciation of the nature and content of directors' duties remains fundamental to the understanding of the oppression remedy, oppression can be found in instances where a director has acted in good faith and in the best interests of the corporation, but where the result of such action is oppressive or unfairly prejudicial to the interests of a corporate stakeholder.⁵⁹ In other words, a breach of statutory or common law duty is not a necessary precondition to a finding of oppression.⁶⁰ In the case of an oppression action, the court has exceptionally wide latitude to make any order it considers reasonable to remedy the prejudice suffered by a complainant. These powers include the power to make orders

against directors to compensate for losses suffered as a result of the conduct of the corporation.

Personal liability under the oppression remedy will depend on the circumstances of the case. However, the discretionary power of the court is limited by two considerations: (i) the remedy should only rectify the oppressive conduct and does not punish and (ii) the remedy should only protect the claimant in his or her capacity as a complainant.

The Ontario Court of Appeal in *Budd v. Gentra Inc.*⁶¹ established a two-step test to be used in determining when an oppression action contains a reasonable cause of action against a director (or officer) personally:⁶²

- Are there acts pleaded against specific directors or officers which could provide the basis for finding that the corporation acted oppressively?
- Is there a reasonable basis in the pleadings on which a court could decide that the oppression alleged could be properly rectified by a monetary order against a director or officer personally?

In *Downtown Eatery*,⁶³ the Court of Appeal, *inter alia*, addressed the question of whether it is appropriate to grant an oppression remedy against the director personally to vindicate claims of creditors of the corporation of which the individual is a director. The Court held that it was not necessary to find that the oppressive conduct was undertaken with the intention of causing harm to the plaintiff. The Court granted judgment against the officers and directors personally for their failure to ensure the protection of the employees' interests in his judgment.

In *BCE* the Supreme Court of Canada also reviewed the oppression remedy under the *CBCA* and held that the Court has broad jurisdiction to enforce "not just what is legal but what is fair".⁶⁴ To determine what is considered just and equitable in each context a Court must look at the reasonable expectations of the stakeholders in regard to their relationship with the Corporation.⁶⁵ The Court also outlined a two-step process to assess a claim of oppression against a director:

- Does the evidence support the reasonable expectation asserted by the claimant?
- Does the evidence establish that the reasonable expectation was violated by

conduct falling within the terms “oppression”, “unfair prejudice” or “unfair disregard” of a relevant interest.⁶⁶

Useful factors in determining the answer to the first question included *inter alia*: looking at general commercial practice, the existing relationship between the parties, mitigation by the claimant, past practice, and the fair resolution of stakeholders competing interests.⁶⁷

To succeed in the second portion of the test, a claimant must establish that the failure by the director to meet their reasonable expectations was the result of unfair conduct and had prejudicial consequences under s. 241 of the *CBCA*.⁶⁸

In the case of conflicting interests, the directors must resolve such conflicting interests according to their fiduciary duty to the corporation. This means that the directors are required to treat the different stakeholders affected fairly, but not equally; which can be accomplished by consultation.

(B) DERIVATIVE ACTION

A derivative action may be brought by parties seeking redress on behalf of the corporation for a breach of the corporation's rights.⁶⁹ Under corporate legislation, a shareholder can apply to the court to bring a derivative action on behalf of the corporation for the purpose of prosecuting, defending or discontinuing an action on the corporation's behalf. The court must be satisfied that the:

- Directors will not bring, diligently prosecute, defend or discontinue the action.
- Shareholder is acting in good faith.
- Action appears to be in the corporation's interests.
- Such action could include for breach of fiduciary duty or negligence.

RISK MANAGEMENT

Apart from the diligent discharge of their duties, there are a number of ways that directors can manage the risks associated with their personal liability. In general, directors should:

- Attend all board meetings and insist on receiving all relevant information relating to matters requiring Board approval in advance of a meeting.

- Ask questions and speak up at meetings.
- Keep personal notes of meetings and review all minutes of meetings when received.
- Insist that the minutes record any disclosure made by a director, or that a director's abstinence or dissent is recorded.
- Read all relevant materials and make independent and informed decisions.
- Keep a file of all notes from meetings and documents.
- Insist upon director liability insurance and indemnification.
- Under the *OBCA* and *CBCA*, there are no restrictions against a corporation purchasing and maintaining insurance for the benefit of directors for a breach of his or her fiduciary duty to the corporation. Corporations will also generally offer indemnities to their directors, and in many circumstances it is legally required to do so. The *OBCA* and the *CBCA* also permit a corporation to insure directors where liability relates to their failure to act honestly and in good faith with a view to the best interests of the corporation, but it does not permit a corporation to indemnify a director for the same.
- Insist that all relevant materials are succinct and comprehensible.
- Carefully read all circulated materials in advance.
- Review Board meeting minutes when received.
- Insist on an effective audit committee.
- Consider obtaining independent legal advice on any major corporate steps, which are being contemplated and on obtaining written profession opinions from specialists such as accountants, valuers and investment advisers in respect of decisions where it would be expected that the directors would inform themselves as to such matters.

- Be alert and responsive to changing circumstances.

As noted above, the defense of due diligence is available for many statutory liability provisions. Accordingly, it is essential for directors to ensure that practices and procedures are in place which require management to make statutory payments and notify directors when the company is unable to make such payments.

MINIMIZING RISK OF STATUTORY LIABILITIES

Steps to be taken for directors to satisfy themselves that the corporation can meet, and is meeting, its statutory obligations to employees include requiring senior management to provide statements on a regular basis attesting to: (a) the timely payment of employee wages (including bonus pay, overtime pay and vacation pay); and (b) the absence or existence of regulatory prosecutions, inspections, or appeals. In times of financial uncertainty, directors should request and receive more frequent reports and assurances from management concerning these matters.

Directors can also be proactive in order to avoid the following specific liabilities:

- **Avoiding Source Deduction Liability:**

While what is considered to be prudent due diligence will vary by the circumstances of each case, Revenue Canada has stated that a corporation can establish a due diligence defence where directors have:

- established an account for withholdings from employees and remittances of source deductions, as well as remittances of GST net amounts;
- call upon financial officers of the corporation to report regularly on the status of the account; and
- obtained regular confirmation that withholdings and remittances have, in fact, been made during all relevant periods.
- **Limiting Environmental Liability:**

In order to minimize potential environmental liability, the minimum standard required of directors in this regard includes:

- ensuring a pollution prevention system is in place including regular supervision and improvement in business methods;
- ensuring officers have been instructed to set up a sufficient system in compliance with environmental laws, that they report back regularly to the directors, and report any substantial non-compliance to the board in a timely manner;
- reviewing environmental reports;
- follow up with officers to ensure environmental matters are being properly addressed; and
- reacting immediately and personally when they have notice of an environmental failure.
- **Avoiding Liability for Employee Pension Plan:**
- A director should insist that a corporation formalize a governance policy that clearly identifies the board's responsibilities and the capacity under which it undertakes to satisfy such responsibilities.
- A director should ensure that he/she reviews the annual actuarial evaluation report, the audit results and all Pension Committee meeting minutes.

CONSIDERATIONS FOR DIRECTORS OF A COMPANY ABOUT TO FILE FOR PROTECTION

When the Board has determined that it is in the best interests for the Company to institute proceedings under either the *CCAA* or the *BIA* the directors also need to ensure that their interests are protected in the interim and going forward in the anticipated restructuring proceedings.

DIRECTORS' AND OFFICERS' CHARGE

In *CCAA* proceedings, in particular, directors are routinely granted protection in the Initial Order made by the Court pursuant to a Directors' and Officers' Charge, ("D&O Charge"). The D&O Charge is meant to protect directors and officers of the company who agree to continue in their positions during the company's restructuring proceedings from certain liabilities for which they might have exposure by reason of continuing to act as a director or officer

of the company during its restructuring proceedings. The amount and priority of the D&O Charge is the subject of much negotiation as among the directors, the company, the company's secured lenders and the Debtor-in-Possession Lender ("DIP Lender"), if a DIP Lender is involved. The directors should ensure that the D&O Charge is (i) adequate in order to cover all, or substantially all, possible liabilities for which they may be liable by reason of continuing as a director of the company (including statutory liabilities, which have accrued for the company immediately prior to the filing date, but are not required to be remitted until after the filing date (*i.e.* GST remittances); and, (ii) not rendered effectively meaningless by reason of its priority in the waterfall of priorities for post-filing charges granted by the Court.

Recent amendments have been made to both the CCAA and the BIA,⁷⁰ which now provide the statutory authority for the court to grant a D&O Charge, on a priority basis, in a BIA proposal or CCAA proceeding. Specifically, the amendments authorize the court to order that the assets of an insolvent company be subject to a priority charge — (*i.e.* D&O charge) — in favour of the directors and officers for an amount reasonably necessary to indemnify them for obligations which they may incur as a director or officer after the BIA proposal or CCAA proceedings are commenced. The court may also order that the security or charge rank in priority over the claims of any secured creditor.⁷¹ That being said, the court shall not make the order if, in its opinion, the company could obtain adequate indemnification insurance for the director at a reasonable cost.⁷² Finally, the court is instructed to include in the order granting a D&O charge a declaration that the charge does not apply in respect of a specific obligation or liability incurred by a director if it is of the opinion that the obligation of liability was incurred as a result of the director's gross negligence or wilful misconduct, or the director's gross intentional fault as applicable in the Province of Quebec.⁷³

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

Directors should also ensure that existing directors' and officers' liability insurance ("D&O Insurance") continues post-filing by the company and that the company is given the authority by the Court to continue to pay the premiums on the D&O Insurance post-filing in order to provide the directors with the

maximum amount of coverage which may be necessary going forward.

TERMS OF THE PROPOSAL OR PLAN OF ARRANGEMENT OR COMPROMISE

The terms of a proposal under the BIA or a plan of arrangement or compromise under the CCAA can also provide protection to directors for claims against directors of the company that arose before the commencement of proceedings and that relate to the obligations of the company for which the directors are by law liable in their capacity as directors for the payment of such obligations. It should be noted, however, that a compromise will not be permitted where claims relate to contractual rights against the directors, or where there are allegations of misrepresentation made by directors to creditors or wrongful or oppressive conduct.⁷⁴

INDEPENDENT LEGAL ADVICE

On account of the uncertainty as to a director's duty to a company's creditors when a company is in the vicinity of insolvency, and the significant liabilities for which a director may be exposed should the company file for protection from its creditors with the Court, or if the company should become subject to involuntary insolvency, or bankruptcy proceedings; the directors of a company which may be experiencing financial difficulties should, at the earliest possible time, seriously consider obtaining independent legal advice in order to protect their interests and minimize their exposure to any liabilities of the company on a go-forward basis.

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¹ Canada Business Corporations Act, R.S.C. 1985, c. C-44, as amended at s. 102 (1).

- ² *Ibid.* at s. 122(1).
- ³ R.S.O. 1990, c. B.16, as amended at s. 134(1).
- ⁴ Barry Reiter, *Directors' Duties in Canada*, 4th Ed. (Toronto: CCH Canadian Ltd., 2009) at 44 ("DDC").
- ⁵ [2004] S.C.J. No. 64, [2004] 3 SCR 461, 2004 SCC 68, aff'g [2003] J.Q. no 505, 224 D.L.R. (4th) 509 (Que. C.A.), rev'g [1998] Q.J. No. 3571, 23 C.B.R. (4th) 200 (S.C.) [*Peoples*].
- ⁶ *Ibid.*, at para. 63.
- ⁷ DDC, *Supra* Note 3 at p. 58. See also *Maple Leaf Foods Inc. v. Schneider Corp.*, [1998] O.J. No. 4142, 42 O.R. (3d) 177 at para. 36; See also *Peoples*, *supra* note 4 at para. 67.
- ⁸ *Supra* note 5.
- ⁹ *Peoples*, *ibid.* at para. 43.
- ¹⁰ [2008] S.C.J. No. 37, [2008] 3 S.C.R. 560, 2008 SCC 69 [*BCE*].
- ¹¹ *Ibid.* at para. 66.
- ¹² *CBCA*, s. 123(1); *OBCA*, s. 135(3).
- ¹³ *CBCA*, s. 123(4).
- ¹⁴ [1995] M.J. No. 182 (Man. C.A.).
- ¹⁵ [1994] B.C.J. No. 553, 25 C.B.R. (3d) 120, 91 B.C.L.R. (2d) 111.
- ¹⁶ *Vopni v. Groewald*, [1991] O.J. No. 3577 (Ont. Gen. Div.) [*Vopni*].
- ¹⁷ [2006] O.J. No. 1234, 26 C.P.C. (6th) 103, 33 B.L.R. (4th) 288 (O.C.J.).
- ¹⁸ S.O. 2000 c. 41.
- ¹⁹ [2006] O.J. No 5185 (S.C.J.).
- ²⁰ R.S.C. 1985, c. C-36 [*CCAA*].
- ²¹ S.O. 2000, c.41, at s. 81.
- ²² Note: these comments assume that the corporation is the plan's administrator, and the pension is a single-employer pension plan that is registered under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.).
- ²³ *Supra*, note 4, p. 520.
- ²⁴ See, for example: Ontario *Pension Benefits Act*, R.S.O. 1990 c. P. 8, s. 110(2).
- ²⁵ *Ibid.* s. 22(5).
- ²⁶ *Supra* note 4, p. 527.
- ²⁷ R.S.C. 1985, c. 1 (5th Supp.).
- ²⁸ *Ibid.* s. 227.1(1).
- ²⁹ *Ibid.* s. 227.1(3).
- ³⁰ S.C. 1996, c. 23.
- ³¹ *Ibid.* s. 46.1(1).
- ³² *Ibid.* s. 39(3).
- ³³ *Ibid.* s. 46.1(3).
- ³⁴ R.S.C. 1985, c. C-8.
- ³⁵ *Ibid.* s. 21.1.
- ³⁶ Canada Revenue Agency Information Circular 89-2R2, "Directors' Liability Section 227.1 of the *Income Tax Act*; Section 323 of the *Excise Tax Act*, R.S.C. 1985, c. E-15; Section 81 of the *Air Travellers Security Charge Act*, S.C. 2002, c. 9, and Subsection 295(1) of the *Excise Act*, 2001, S.C. 2002, c. 22" (March 2006) <<http://www.cra-arc.gc.ca/E/pub/tp/ic89-2r2-e.pdf>>.
- ³⁷ R.S.C. 1985, c. E-15, c. 330.
- ³⁸ *Ibid.* at s. 323(2).
- ³⁹ *Occupational Health and Safety Act*, R.S.O. 1990, c. O.1, s. 66.
- ⁴⁰ *Supra*, note 4 at p. 506.
- ⁴¹ *R. v. Bata Industries Limited*, [1992] O.J. No. 236, 9 O.R. (3d) 329 (O.C.J.), rev'd on other grounds, [1993] O.J. No. 1679, 14 O.R. (3d) 354 (Gen. Div.), rev'd on other grounds, [1995] O.J. No. 2691, 25 O.R. (3d) 321 (Ont. C.A.).
- ⁴² See, for example: *Retail Sales Act*, R.S.O. 1990, c.R.31, s. 43.
- ⁴³ *Ibid.* In several provinces like Ontario, RST has now been harmonized for collection and remittance purposes.
- ⁴⁴ R.S.C. 1985, c. C-46.
- ⁴⁵ R.S.C. 1985, c. B-3.
- ⁴⁶ *Ibid.* s. 101.
- ⁴⁷ *Ibid.* s. 204.
- ⁴⁸ *Ibid.* s. 159.
- ⁴⁹ *Ibid.* s. 96.
- ⁵⁰ *Supra* note 19.
- ⁵¹ *Ibid.* s. 5.1.
- ⁵² *Ibid.*
- ⁵³ R.S.C. 1985, c. B-3.
- ⁵⁴ S.C. 2005, c.47, s.1.
- ⁵⁵ *Ibid.* s. 2(1); "Wages" is defined to include salaries, commissions, compensation for services rendered, vacation pay, severance pay, termination pay and any other amounts prescribed by regulation.
- ⁵⁶ *DDR*, *Supra*, note 3 at p. 498 and *Supra*, note 52, ss. 4, 7.
- ⁵⁷ *Supra*, note 36, s. 36. See also Lloyd Houlden, Geoffrey Morawetz and Janis Sarra, *The 2010 Annotated Bankruptcy and Insolvency Act*, (Toronto: Carswell, 2009).
- ⁵⁸ *CBCA*, s. 241; *OBCA*, s. 248.
- ⁵⁹ See also *Palmer v. Carling O'Keefe Breweries of Canada Ltd.*, [1989] O.J. No. 32, 41 B.L.R. 128 (Pmt. Div. Ct.); *Brant Investments Ltd. v. Keep Rite Inc.*, [1991] O.J. No. 683, 3 O.R. (3d) 289 (C.A.) at p. 308.
- ⁶⁰ *820099 Ontario Inc. v. Harold E. Ballard Ltd. (1991)*, [1991] O.J. No. 1082, 3 B.L.R. (2d) 113 (Ont. Div. Ct.).
- ⁶¹ [1998] O.J. No. 3109, 43 B.L.R. (2d) 27 (Ont. C.A.).
- ⁶² *Ibid.* at 43.
- ⁶³ [2001] O.J. No. 1879, 54 O.R. (3d) 161.
- ⁶⁴ *Supra* note 10, para 58.
- ⁶⁵ *Supra*, note 10, paras 58 and 59.
- ⁶⁶ *Supra*, note 10, paras. 68-72.
- ⁶⁷ *Supra* note 10, para 89.
- ⁶⁸ *Supra* note 10, para. 95.
- ⁶⁹ *CBCA* s. 239; *OBCA* s. 246.
- ⁷⁰ *CCAA* s. 11.51(1); *BIA* s. 64.1(1).

⁷¹ CCAA s. 11.52(2); BIA s. 64.1(2).

⁷² CCAA s. 11.52(3); BIA s. 64.1(3).

⁷³ CCAA s. 11.52(4); BIA s. 64.1(4).

⁷⁴ CCAA s. 5.1; BIA, s. 50(13) and (14).

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