Derivative Claims as a Means of Increasing Creditor Recoveries

David Gruber and Mario Mainella[*]

1. INTRODUCTION

The recent decision of the Ontario Court of Appeal upholding the trial judgment of Gans J. in *Livent Inc. (Receiver of) v. Deloitte & Touche*[1] is a rare but fascinating example of a case where creditors of an insolvent corporation have seen their recovery materially increased through a derivative claim — that is, a claim for damages suffered by the corporation. *Livent* stands for the proposition that the fact that such damages will ultimately accrue to the benefit of the creditors of the corporation is not in itself a valid objection to the claim. This article considers the extent to which derivative claims could be pursued more widely in Canadian corporate insolvencies to increase creditor recoveries.

This article reviews the *Livent* decision, and the potential implications that can be extrapolated from it in the context of claims made by receivers, trustees and liquidators for harms done to the insolvent corporation. We note various reasons why such claims are not more often brought or pursued are considered. In addition, consideration is given to potential changes in practice that might increase the frequency of derivative claims being pursued by insolvency professionals appointed in a corporate liquidation.

The article then turns to the "restructuring" context, namely proceedings under the *Companies' Creditors Arrangement Act*[2] (CCAA), and Part III Division 1 Proposals under the *Bankruptcy and Insolvency Act*[3] (BIA). Reference to the practice of pursuing such claims in Chapter 11 corporate insolvencies in the United States will be considered, as will the extent to which that practice could be adapted to the Canadian context.

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* David Gruber is a partner at Farris, Vaughan, Wills & Murphy LLP and Mario Mainella is Senior Vice President at The Bowra Group Inc.

1 2016 ONCA 11, 2016 CarswellOnt 122 (Ont. C.A.) [*Livent*], leave to appeal allowed 2016 CarswellOnt 9347, 2016 CarswellOnt 9348 (S.C.C.), affirming 2014 ONSC 2176, 2014 CarswellOnt 4365 (Ont. S.C.J. [Commercial List]).

2 R.S.C. 1985, c. C-36 [CCAA].

3 R.S.C. 1985, c. B-3 [BIA].

2. DERIVATIVE ACTIONS PRIOR TO INSOLVENCY

Quite apart from insolvency, the derivative action has a long history in Canadian corporate law. Before considering derivative claims in the context of a formal insolvency proceeding, it is instructive to review the bringing of derivative actions by creditors prior to such a proceeding being commenced.

Under Canadian corporate statutes, a "complainant" may seek leave to commence an action in the name of the corporation against other entities, including the corporation's directors, to enforce any right, duty or obligation enforceable by the corporation, or to recover any damages for any breach of those rights, duties or obligations.[4]

The term "complainant" has different meanings in different corporate statutes. In the federal statute, "complainant" captures a wide class, including current and former registered holders or beneficial owners of securities of a corporation, current and former directors and officers, and any other person who, in the discretion of the court, is a proper person to make an application.[5] In some provincial statutes, however, a "complainant" can only be a shareholder or director, though "appropriate persons" may be recognized under the definition of shareholder.[6]

As to whether a creditor can qualify as a "complainant", Cullity J. in *Millgate Financial Corp. v. BCED Holdings Ltd.* held:

> [97] ... If, as I believe to be correct, the appropriate remedy for shareholders who wish to challenge the validity of a transaction on that ground is by way of a derivative action pursuant to section 239 of the *CBCA* — ... — the same procedure should be available to creditors as "complainants" for purposes of the section if, by virtue of the insolvency of the corporation — or its near insolvency — their interests are to be considered to be those of the corporation.[7]

Consistent with that view, the Supreme Court of Canada in *People's Department Stores Ltd. (1992) Inc., Re* noted in *dicta*:

> [49] The fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to, *inter alia*, the exercise of

4 See e.g. *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 239 [CBCA].

5 *Ibid.* s. 238.

6 See e.g. *Business Corporations Act*, S.B.C. 2002 c. 57, s. 232(1) [BCBCA].

7 2003 CarswellOnt 5547, [2003] O.J. No. 5555 (Ont. S.C.J. [Commercial List]) at para. 97, affirmed 2005 CarswellOnt 486 (Ont. C.A.), leave to appeal refused 2005 CarswellOnt 4332, 2005 CarswellOnt 4333 (S.C.C.).

> discretion by a court in granting standing to a party as a "complainant" under s. 238(d) of the *CBCA* as a "proper person" to bring a derivative action in the name of the corporation under ss. 239 and 240 of the *CBCA*, or to bring an oppression remedy claim under s. 241 of the *CBCA*.[8]

Other Canadian courts have also on occasion held that creditors were appropriate persons to act as "complainants" in derivative action proceedings.[9]

To obtain leave to bring a derivative action, the complainant must satisfy three requirements. Firstly, the complainant must provide notice to the directors of the corporation with respect to the complainant's intent to bring the application. Secondly, the complainant must be acting in good faith. Thirdly, it must be established that it is in the best interests of the corporation that the action be brought.[10] The requirement that it must appear to be in the best interests of the corporation has been held to mean that the proposed action must be arguable or have a reasonable prospect of succeeding and, if successful, would maximize the value of the corporation.[11] This analysis may require consideration of the interests of the shareholders, employees and other stakeholders.[12]

It is important to recognize that as the nature of a derivative action is an action on behalf of the corporation, any damages which the defendants are required to pay will go to the corporation itself, and not directly to a creditor or other interested stakeholders.[13] For this reason, derivative actions will seldom be a useful tool for creditors to secure or improve their recoveries. Even if such an action were to be successful, the creditor must then go on to prove its debt and execute upon the judgment.

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8 2004 SCC 68, 2004 CarswellQue 2862, 2004 CarswellQue 2863 (S.C.C.) [*People's*].

9 See e.g. *Valor Invest Ltd. v. Vista Online Ltd.*, 2004 BCSC 1787, 2004 CarswellBC 2963 (B.C. S.C.); *A E Realisations (1985) Ltd. v. Time Air Inc.*, 1995 CarswellSask 68, 131 Sask. R. 249 (Sask. C.A.); *Levy-Russell Ltd. v. Shieldings Inc.*, 1998 CarswellOnt 3455, 41 O.R. (3d) 54 (Ont. Gen. Div.), additional reasons 1998 CarswellOnt 5916 (Ont. Gen. Div.), leave to appeal refused 1998 CarswellOnt 4778 (Ont. Gen. Div. [Commercial List]); *First Edmonton Place Ltd. v. 315888 Alberta Ltd.*, 1988 CarswellAlta 103, 60 Alta. L.R. (2d) 122 (Alta. Q.B.), reversed on preliminary grounds 1989 CarswellAlta 181, 71 Alta. L.R. (2d) 61 (Alta. C.A.); *Briere Sound Ltd. v. Briere*, 2014 BCSC 417, 2014 CarswellBC 696 (B.C. S.C.).

10 See e.g. CBCA, *supra* note 3, s. 239(2).

11 *Carr v. Cheng*, 2005 BCSC 445, 2005 CarswellBC 695 (B.C. S.C. [In Chambers]).

12 *Ibid.* at para. 25.

13 Carol Hansell, *What Directors Need to Know: Corporate Governance* (Toronto: Carswell, 2015) at 151.

3. DERIVATIVE CLAIMS IN LIQUIDATION CONTEXT

The liquidation context presents a more straightforward mechanism of pursuing derivative claims for the benefit of creditors, in that the insolvency professional who is appointed receiver, trustee or liquidator stands in the shoes of the corporation, and may pursue causes of action belonging to the corporation without the cumbersome requirement of a leave application under business corporations statutes.[14]

That such claims have only infrequently been pursued in liquidations is largely attributable to difficulty in funding their evaluation and prosecution, a topic which is discussed further below. But what has also been lacking is a loss causation and damages framework that connects the claim with the corporation's insolvency. If it is possible to connect wrongful conduct by officers, directors, professional advisors or others to the losses that have resulted in the corporation being in liquidation, then such claims would as a matter of course be evaluated as a potential avenue of recovery.

In the United States, there has been much discussion about whether "deepening insolvency" might itself give rise to a cause of action. Up until around 2006, there appeared to be growing acceptance that fraudulent expansion of corporate debt and prolongation of corporate life which resulted in less money being available to creditors could give rise to liability independent of claims for breach of fiduciary duty owed to the corporation.[15] More recently, some U.S. courts have negated such a theory of liability, and even have questioned "deepening insolvency" as a theory of damages where other causes of action for wrongful injury to the corporation could be proved, while other courts have continued to develop the theory of deepening insolvency either as a cause of action or as a damages model.[16]

The effect of the appellate decision in *Livent* appears to be that in Canada, recovery of damages in the form of an increased liquidation deficiency, which is somewhat analogous to damages for "deepening insolvency", has now been established as being consistent with established theories of loss causation and damages in negligence. The extent to which such damages may be recoverable may depend on the nature of the cause of action and the defences available to the defendant.

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14 In receiverships this is a matter dealt with under the order granting the receiver's powers. Under the BIA, *supra* note 3, see s. 38(4).

15 Russell C Silberglied, "Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment" (2015) 10 J Bus & Tech L 181 at 210-11.

16 *Ibid.* at 211-14.

The facts giving rise to the *Livent* litigation are somewhat notorious. The corporation was established and run by Garth Drabinsky and Myron Gottlieb. For a number of years spanning 1991 to 1998, they orchestrated an accounting fraud, which made it appear that the corporation was more financially sound than it actually was. This in turn allowed Livent to access the capital markets for approximately $350 million in order to finance its ongoing cash needs. When the fraud was discovered in 1998, Livent filed for creditor protection and was subsequently placed in receivership. Its assets were sold for US$144 million. Gottlieb and Drabinsky were charged criminally, convicted and sent to jail.[17]

In 2001, Roman Doroniuk was appointed as special receiver of Livent with the power to commence and prosecute an action against Deloitte & Touche ("Deloitte"), Livent's auditor between 1989 and 1998, for negligent performance of audits between 1991 and 1998. The lawsuit, which claimed damages of $450 million, was commenced in February 2002 but held in abeyance during the criminal proceedings against Drabinsky and Gottleib. It was revived in 2009 following their convictions.[18] Following a 68-day trial, Gans J. held that Deloitte had not been negligent in respect of its pre-1996 audits; had been negligent in respect of its 1996 audit but without any damages being caused to Livent; and had been negligent in its engagements in 1997 and 1998 for which Livent suffered damages of $84,750,000 plus interest.[19]

The principal issues on the appeal were whether the negligence claim against Deloitte was precluded under the doctrine of *ex turpi causa* (as a result of the plaintiff's own illegality), and whether its actions were the proximate cause of the damages found by Gans J. to have been caused to Livent.[20]

It is the latter issue that is considered here. Its permutations were summarized by R.A. Blair J.A., writing for the Court of Appeal, as variations on the theme that the claim brought against Deloitte in the name of Livent was merely a "proxy claim" for the losses suffered by Livent's creditors.[21] The Court rejected Deloitte's position, holding that, "It impermissibly conflates damages suffered by the corporation with the distribution of those damages, once recovered, to creditors and other stakeholders, as part of the assets of the corporation ..."[22] In other

17 *Livent, supra* note 1 at paras. 2-3, 17-31, 37-49.

18 Drew Hasselback, "It's Livent — the Sequel", *Financial Post* (19 March 2013), online: <http://business.financialpost.com/legal-post/its-livent-the-sequel>.

19 *Livent, supra* note 1 at para. 5.

20 *Ibid.* at para. 6.

21 *Ibid.* at para. 56.

words, the fact that the creditors are the ones that will benefit does not mean that the claim can proceed as a derivative claim for the corporation's damages.

The theory of damages that the special receiver had advanced was that Livent's damages were to be measured by "... The change or increase in the losses sustained by Livent between the time of Deloitte's breach and the time of Livent's eventual CCAA filing, if not its insolvency."[23] Both sides had prepared expert reports that calculated damages on that approach according to the formula: loss (L) = actual liquidation deficit (ALD) - estimated liquidation deficit (ELD), where the estimated liquidation deficit is the estimated loss on the sale of Livent's assets which would have been realized if, by virtue of a proper application of the auditor's standard of care, Livent would have been unable to access capital markets and forced instead into a formal insolvency.[24]

In upholding the damages award made by Gans J., the Court of Appeal concluded that "but for" causation of that loss had been made out because an objective investigation into Livent's financial statements by September 1997 would have revealed the fraud, with the same consequences as actually occurred when it was revealed a year later. As such, Deloitte's negligence was at least a part of the cause (referring to *Athey v. Leonati*[25]) of the injury in the form of Livent's increased liquidation deficit.[26] The Court then went on to deal with the issue of remoteness, and the assertion by Deloitte that the damages awarded by Gans J. were tantamount to damages for "deepening insolvency", and ought to be rejected for the same reasons some U.S. courts have rejected the "deepening insolvency" theory.[27]

In rejecting this contention, the Court of Appeal held:

> [338] I do not think it necessary, or useful, in this case to determine whether "deepening insolvency" is to be recognized as a cause of action or a theory of damages in Canada. It is a label that describes many of the same considerations that underlie the debate about whether the damages that Livent claims are available under traditional tort and contract principles. In my view, they are, and in this respect I agree with the statement of the Court of Appeals for the Third Circuit in *Thabault*, at p. 523, that "traditional damages, stemming from actual harm of a defendant's

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22 *Ibid.* at para. 57.

23 *Ibid.* at para. 61 [Underlining omitted].

24 *Ibid.* at paras. 62-63, 306.

25 1996 CarswellBC 2295, 1996 CarswellBC 2296, [1996] 3 S.C.R. 458 (S.C.C.) at para. 17.

26 *Livent, supra* note 1 at paras. 311-22.

27 *Ibid.* at paras. 324-37.

negligence, do not become invalid merely because they have the effect of increasing a corporation's insolvency."[28]

The Court of Appeal also went on to distinguish other Commonwealth authority which has held that damages for increased business losses from keeping the corporation in business are unrecoverable without the wrongdoing being the dominant cause of that loss, and without something more than losses occasioned by the ordinary risks associated with carrying on the business.[29] In the context of the specific facts, the Court found that it was eminently foreseeable that failure to properly audit the financial statements would enable Livent, which was always short of cash and in need of capital infusions, to access the capital markets, thereby deepening its liquidation loss.[30] The Court concluded its findings on damages and loss causation as follows:

> To conclude, Deloitte's negligence caused Livent to continue to operate in circumstances in which it was reasonably foreseeable both that the company would continue to accumulate increased liabilities through its access to the capital markets, but also — perhaps even more significantly — that it would have no means of paying down those liabilities because of the cash-burn nature of Livent's money-losing business. Deloitte's negligence did not merely create the opportunity for Livent to stay in business (*Galoo*). It created the opportunity for Livent to stay in business *and* for the fraudsters to continue to take Livent to the capital markets, thus enhancing the losses that would otherwise have been incurred had Livent remained in business during the delta period. The enhanced liabilities resulted from Deloitte's negligence (*Sasea, Temseel,* and *Bilta*), would not have been incurred "but for" that negligence (*Clements* and *Athey v. Leonati),* were a foreseeable risk of Livent's continuing in business, and the harm incurred was therefore not "too unrelated to the wrongful conduct to hold [Deloitte] fairly liable" (*Mustapha*).[31]

In approaching loss causation and damages in this fashion, the Court of Appeal provides a framework which is potentially applicable in a large number of different situations. For example, the same facts would presumably give rise to derivative claims against Gottlieb and Drabinsky for breach of fiduciary duty to Livent, and in the event there were directors and officers insurance that would respond to such a claim, that

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28 *Ibid.* at para. 338.
29 *Ibid.* at paras. 339-50.
30 *Ibid.* at paras. 351-56.
31 *Ibid.* at paras. 378-79.

would potentially present an avenue of recovery for the losses prior to 1997.

4. BUSINESS JUDGMENT RULE

Absent fraud, however, the viability of derivative claims against officers and directors for damages for an increased liquidation deficit must be assessed in light of the generous protection afforded in Canada by the business judgment rule.[32] Provided management incurred an additional liquidation deficit in good faith, with at least some prospect that the business could be turned around, liability likely would not flow. If, on the other hand, that were not the case, such as when additional debt is incurred after a decision has been made to file a formal insolvency proceeding but before the proceeding is filed (rather than shifting to COD terms), the *Livent* damages model may provide a rationale for recovery from the directors or officers in respect of that additional debt. Furthermore, even given the broad latitude afforded by the business judgment rule, some derivative claims against management, such as where there is a fair argument that business judgment was exercised recklessly, or was exercised contrary to professional advice, leading to an increased liquidation deficit may well have settlement value, particularly where there is a directors and officers insurance policy that would respond.

That said, the difficulty in liquidation scenarios is always how to fund claims to be brought against third parties. It is for that reason that the structure of section 38 of the BIA contemplates creditors who are funding such claims generally taking the benefit of them personally, rather than the benefit enuring to the estate.

5. POTENTIAL ALTERNATIVES

One avenue that could enable such claims to be pursued more frequently and with wider benefit would be increased use of contingency fee arrangements. An instructive example is *Orion Truck Centre Ltd., Re.*[33]

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32 See *BCE Inc., Re*, 2008 SCC 69, 2008 CarswellQue 12595, 2008 CarswellQue 12596 (S.C.C.) at para. 40; *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, 2002 CarswellOnt 2096 (Ont. S.C.J. [Commercial List]) at paras. 152-153, additional reasons 2002 CarswellOnt 3579 (Ont. S.C.J. [Commercial List]), leave to appeal refused 2004 CarswellOnt 691 (Ont. C.A.), affirmed 2004 CarswellOnt 691 (Ont. C.A.).

33 2005 BCSC 182, 2005 CarswellBC 286 (B.C. S.C.), affirmed 2005 BCSC 1411, 2005 CarswellBC 2340 (B.C. S.C.) [*Orion 2*], reversed 2006 BCCA 418, 2006 CarswellBC 2449 (B.C. C.A.) [*Orion 3*], additional reasons 2007 CarswellBC 307 (B.C. C.A.), leave to

In that case, certain unsecured creditors of the bankrupt proposed to challenge the validity of the secured creditor's security by way of a section 38 BIA claim, which they proposed to buy for $1, together with a guarantee of $2,000 towards the trustee's costs. When the trustee convened a meeting of the inspectors to consider that proposal, the inspector requested that the trustee investigate whether it would be possible instead to have the claim proceed instead on a contingency fee basis. The meeting was adjourned to enable the trustee to investigate, and it was determined that counsel was prepared to proceed on a contingency fee retainer, on the basis they would be entitled to 20% of the amount received if the security interest were successfully challenged. An application under section 38 by the original creditors who proposed taking the claim was then successfully opposed by the trustee.[34]

The challenge to the security interest was successful, and over $1.8 million was recovered for the estate, which meant that instead of a nil recovery, the unsecured creditors would receive a dividend of $0.32 on the dollar.[35] The solicitors then issued a bill according to the contingency fee agreement, which was challenged by the disappointed formerly-secured creditor.[36] The Registrar held that in approving the fees under section 197 of the BIA and in the context of British Columbia's *Legal Professions Act*, she was not bound to apply the agreement, but instead had to determine what a reasonable fee was on a *quantum meruit* basis. She determined that although a reasonable fee might have been $40,000 or $50,000 if not for the contingency fee agreement, in the circumstances, where the solicitors bore of the risk of non-payment, a reasonable fee of $100,000 was appropriate.[37] This was less than one-third of the amount to which the solicitors would have been entitled if the contingency fee agreement were applied.

The result was affirmed by Brown J. in the British Columbia Supreme Court,[38] but subsequently reversed in the British Columbia Court of Appeal, which allowed the trustee's appeal and approved the solicitors receiving the entirety of their 20% contingency fee. In reaching that conclusion, Lowry J.A. for the Court held:

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appeal refused 2007 CarswellBC 813, 2007 CarswellBC 814 (S.C.C.) [*Orion Truck Centre*].

34 *Ibid.* at paras. 7-13.

35 *Ibid.* at paras. 14-16, 50.

36 *Ibid.* at paras. 32-35.

37 *Ibid.* at paras. 36-58.

38 *Orion 2, supra* note 33.

> [11] To hold that in bankruptcy proceedings solicitors' accounts can only be taxed on a *quantum meruit* basis would impair, if not largely defeat, the ability of trustees to enter into contingent fee agreements with solicitors in circumstances where there may be no alternative prospect of advancing the interests of the creditors that a trustee is duty-bound to serve. Where as in bankruptcy there is often little or no money available for litigation expenses, the use of contingent fees can provide an important access to justice that otherwise might well be lost, although solicitors must recognize that it remains open to the court to decline to approve an account that exceeds 10% of the estate and weigh that possibility as part of the risk they take.
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> [12] It is common ground that the cases reflect recognition that the intent of the BIA is in general terms to permit the trustee to administer an estate under the supervision of inspectors without undue court interference. The solicitors' account in this instance has carried the approval of both the trustee and the inspector throughout. There is, in the circumstances, no compelling justification for the court denying its approval in the complete absence of any basis on which it could be said that the contingent fee charged is unreasonable. There is nothing that should have caused the Registrar to decline to give effect to the CFA and tax the solicitors' account on the basis of *quantum meruit*.[39]

While the ultimate decision in *Orion Truck Centre* strongly supports the validity of contingency fee agreements as a mechanism to enable derivative claims to be pursued in the liquidation context, there is still the problem of ensuring that the insolvency professional who has conduct of the proceeding is not exposed to an award of costs in circumstances where there are insufficient funds in the estate to satisfy such an award, as will often be the case. For that reason, having creditors take on a derivative claim under section 38 of the BIA is less risky to the trustee.

It may be that in some circumstances, counsel who agrees to take the matter forward on a contingency fee basis will provide the trustee, receiver or liquidator with an indemnity against costs in exchange for a higher contingency return. However, given that such counsels' fee could potentially be reviewed by a disgruntled creditor, as occurred in *Orion Truck Centre*, it may be advisable to seek approval by the court for such an arrangement in advance, on notice to all stakeholders.

For insolvency files with potentially high dollar value derivative claims, another possibility may be to access the growing third party litigation funding sector. Third-party litigation funding is a mechanism whereby an investment fund raises capital to invest in funding litigation (including paying for legal fees and disbursements) in exchange for

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39 *Orion 3*, *supra* note 33 at paras. 11-12.

receiving a portion of the outcome as a success fee. Such funds have been active in the U.K. and Australia for some time, and for the first time, a Canadian branch of one established fund recently opened in Toronto.[40] It may well be that third-party litigation funding firms will be able to be more flexible and innovative than law firms (given their access to investment capital and business model) in providing a vehicle by which derivative claims can be pursued and liquidation scenarios, while at the same time offering a means to protect or indemnify the insolvency professional against unfunded costs exposure. However, given that such a litigation funder would expect to participate in any recovery, it would again be advisable for advance approval to be sought from the court on notice to all stakeholders.

6. DERIVATIVE CLAIMS IN THE "RESTRUCTURING" CONTEXT

The "restructuring" context here refers to CCAA proceedings and Part III Division 1 proposal proceedings under the BIA. The term "restructuring" is used advisedly, since in the early 21st century, the frequency of actual restructuring, in the sense of equity or debt recapitalization, which takes place under these statutes, has been noticeably reduced. Most recapitalization is taking place under business corporation's statutes, while the CCAA and the BIA proposal provisions are most frequently used instead to preserve enterprise value through going concern sales, and in some instances to monetize corporate attributes.

The general pattern is the same under Chapter 11 in the United States, except that derivative claims are often pursued there as a means of achieving some return for unsecured creditors. As one U.S. commentator has said:

> One increasingly prevalent pattern in Chapter 11 cases is:
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> 1. The lenders and the company management agree to a series of forbearance agreements;
> 2. The lenders strengthen their collateral positions;
> 3. The debtor's collateral will not repay the debt;
> 4. The debtor and the lenders agree that the debtor will file for bankruptcy to sell the debtor's assets as a going concern;

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40 Yamri Taddese, "Aussie litigation funding company comes to Canada", *Law Times* (14 March 2016).

5. The assets are sold; and
6. Avoidance claims held by the debtor are left for the creditors' committee to pursue.

> In this scenario, it is inevitable that creditors will pursue director and officer claims.
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> If the debtor had alternatives, the creditors' committee (or the trustee) will seek to hold the officers and directors liable for the economic train wreck. Counsel for the committee (or the trustee acting for the creditors) are likely to have a hostile view of managers' conduct. Therefore, lawyers representing corporate officers and directors must understand the duties of officers and directors when the company is in financial difficulty, and the impact a bankruptcy filing may have on otherwise available defenses and protections.[41]

It appears that this difference in pattern is attributable to the structural difference of Chapter 11 proceedings versus Canadian restructuring proceedings, and in particular the provisions in the U.S. *Bankruptcy Code* for an unsecured creditors committee and, in some cases, a Chapter 11 trustee — functions of which are performed, if at all, in the Canadian context by the monitor or proposal trustee.

Most significantly, for present purposes, the unsecured creditors committee in Chapter 11 proceedings in the United States not only monitors the debtor-in-possession, but also has substantial powers to investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business, and any other matter relevant to the case or formulation of a plan.[42] In carrying out those investigative duties, a creditors committee does not act on behalf of the corporation, but rather on behalf of the group of creditors it represents.[43] It has been held that in furtherance of these powers, an unsecured creditors committee may be given access to financial records, particularly where they may shed light on allegations of misconduct, mismanagement, and irregularity in the management of the debtor's affairs.[44]

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41 Jeffrey Baddeley, "Defending Directors and Officer Against Breach of Fiduciary Duty Claims in Bankruptcy", *Bloomberg BNA* (27 September 2012) online: < www.bna.com/defending-directors-and-officers-against-breach-of-fiduciary-duty-claims-in-bankruptcy/ > .

42 See *United States Bankruptcy Code*, 11 U.S.C. § 1103(c)(2) [USBC].

43 *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir., 1993) at 1315-1316.

44 *In re International Horizons Inc.*, 689 F.2d 996 (11th Cir., 1982) at 1103; *In re Kaiser Steel Corp.*, 84 B.R. 202 (Bkcty. D. Colo., 1988) at 206; *In re Evans Prods. Co.*, 58 B.R. 572 (S.D. Fla., 1985) at 576.

A majority of circuits in the U.S. federal court system have established a form of derivative action somewhat analogous to derivative actions under Canadian incorporation legislation within the context of a Chapter 11 proceeding. Generally speaking, these courts will grant standing to an unsecured creditors committee to commence an adversarial proceeding to pursue avoidance actions (i.e. recovery of fraudulent conveyances or fraudulent preferences), or to recover damages done to the corporation from activities of directors or officers, professional advisors, or creditors, provided that they plead a "colourable claim" (meaning one that would survive a summary dismissal motion), that the debtor in possession unjustifiably refuses to pursue or has given them permission to pursue, and whether it is in the interests of the estate that the claim be pursued having regard to the probability of financial recovery and the cost of achieving it.[45] The majority of the Third Circuit *en banc* in the *Cybergenics* case explained that such standing is necessary to combat the "fox guarding the henhouse" problem, namely that the same management of the debtor-in-possession will likely have caused or sanctioned the circumstances giving rise to the claim, and therefore may be unable, unwilling or complicit such that there can be no expectation of the debtor-in-possession pursuing the claim.[46]

An illustration of how such derivative standing can operate is to be found in the decision in *In re Dewey & LeBoeuf LLP*.[47] In that case, the unsecured creditors committee sought standing to sue the debtor law firm's former chairman, executive director and chief financial officer for mismanagement leading to the firm's insolvency and demise. Each of them carried substantial insurance against such a claim. The application contemplated that there would ultimately be a plan of arrangement which would establish a liquidation trust, and the proceeds of the action, if any would be paid into the trust and distributed to the creditors. It was anticipated the claim would be pursued on a contingency fee basis. In granting standing, Judge Glenn held:

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45 See especially *In re STN Enterprises*, 779 F.2d 901 (2d Cir., 1985); *In re Commodore International, Ltd.*, 262 F.3d 96 (2d Cir., 2001); *In re AppliedTheory Corp.*, 493 F.3d 82 (2d Cir., 2007); *Official Committee of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir., 2003) (*en banc*) [*Cybergenics*]; *In re Gibson Group, Inc.*, 66 F.3d 1436 (6th Cir., 1995). The Fourth Circuit, the First Circuit, the District of Columbia and the Tenth Circuit have yet to endorse such derivative claim standing, and no case has been brought before the United States Supreme Court.

46 *Cybergenics, supra* note 45.

47 2012 Bankr. LEXIS 5536 (Bkcty. S.D.N.Y., 2012).

> Applying the applicable standards to the facts alleged in the Motion, the Court concludes that the Unsecured Committee has established a proper basis to proceed with claims against Davis, DiCarmine and Sanders. The allegations made in the Motion appear to assert facially-valid claims that would be sufficient to withstand a motion to dismiss for failure to state a claim. Those three individuals vigorously contest the allegations made by the Unsecured Committee, but the present Motion is not the place to resolve what will likely be disputed issues of fact and law. Because the Debtor has consented to the Unsecured Committee being granted standing to pursue the claims, the three part test described above applies.
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> First, the Motion meets the standard for establishing a colorable claim against the Defendants. Taking the allegations in the Motion as true, the Defendants engaged in reckless mismanagement of the Firm and breached their fiduciary duties by: (i) acting in their own self-interest to the detriment of the Firm; (ii) concealing the Firm's true financial well-being from the partners and creditors; (iii) making excessive distributions to certain partners, regardless of ownership share, while having knowledge (actual or constructive) that the Firm was on the brink of insolvency; and (iv) entering guaranteed compensation agreements with existing and new partners that were above-market and not tied to the partner's future performance. These allegations, if true, would likely entitle the estate to a monetary judgment that could be paid from the $50 million Policies covering such actions by former directors of the Firm.
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> Second, the Motion meets the two-prong test from *Commodore* because granting the Unsecured Committee standing to pursue the claims is in the best interests of the estate and is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceeding. If the allegations asserted in the Motion are proven to be true, the estate may well be able to recover for any damages caused by the Defendants' allegedly reckless behavior and breaches of fiduciary duty; any substantial recovery would benefit the estate and its creditors. The argument whether the "insured versus insured" exclusion to coverage applies under the Policies to claims prosecuted by the Unsecured Committee is important, but that issue cannot be resolved with the current Motion. The outcome of that issue would not, in any event, be determinative. The three proposed Defendants all appear to be solvent potential defendants; in the event litigation of the claims results in a settlement or judgment, a substantial recovery is possible whether or not insurance coverage is available.

One interesting question that arises in the U.S. jurisprudence is whether the debtor-in-possession retains authority to settle derivative litigation that the court has authorized the unsecured creditors committee to pursue on the estate's behalf. It appears that in some cases, where to

do so is in the overall interests of the restructuring proceeding, the debtor-in-possession may be able to do so.[48]

The other means by which derivative claims might be pursued in Chapter 11 proceedings is if a Chapter 11 bankruptcy trustee is appointed.[49] In that circumstance, the claim would be brought in a fashion analogous to one brought by a receiver, trustee or liquidator in a Canadian liquidation proceeding (or in Chapter 7 in the U.S.).

Of course, in Canada there is no requirement for specific constituencies, such as unsecured creditors, to be given standing, representation or funding in restructuring proceedings. Sometimes this is done on an *ad hoc* basis through an order appointing representative counsel for a particular constituency. While this might be done more commonly, there may be situations where unsecured creditors, or some other similar constituency, might through formal representation and funding be seen to attempt to hijack the process, or to use it for collateral purposes.

This different structure of Canadian restructuring proceedings calls into question whether there is a route by which derivative claims can be pursued effectively within them. Certainly, it has not been the culture of our restructuring proceedings to entertain such claims with any frequency. Rather, the culture of our proceedings has tended to view litigation with disfavour, indeed as an undesirable diversion from the goal of completing a restructuring and closing the case. But given that our insolvency restructuring proceedings are infrequently used nowadays for recapitalization of equity or debt, but rather at best are mostly a means of liquidating with the highest enterprise value, it may be time that that culture is re-evaluated. In an economy where a corporation's entire balance sheet can be and often is fully encumbered by secured debt, it is time that we took seriously any avenue that could provide recovery to the most vulnerable economic constituents. If pursuing derivative claims can be done on a cost effective basis, such as through contingency fees or third-party litigation funding, then serious consideration should be given to such claims being pursued.

To that end, it is suggested that it should become a regular duty of monitors and proposal trustees to apply their professional judgment and investigate and report specifically upon potential derivative claims against directors and officers, professional advisers and other third

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48 Elliot Moskowitz & Gerald M Moody Jr, "The Authority of a Debtor to Settle Estate Claims Brought by a Committee" (2010) 29:5 Am Bankr Inst J.

49 See USBC, *supra* note 42, § 1104; *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463 (3d Cir., 1998).

parties, including for fraudulent conveyance is or fraudulent preferences to bring to the attention of the courts and stakeholders. Such an investigation should, of course, be proportional having regard to the economic status of the debtor and stakeholders. But given that the most vulnerable stakeholder constituencies will not be organized or funded to undertake such an investigation themselves, and will not have access to the necessary facts and records to do so, in the absence of any statutory reform creating something like the Chapter 11 unsecured creditors committee, it can only fall to the monitor or proposal trustee to undertake such a task.

If the monitor or proposal trustee identifies derivative claims that any affected creditor consider it ought to be pursued, the court having conduct of the proceeding should entertain applications for leave to commence a derivative action pursuant to the provisions of the relevant business corporation's statute of the debtor — e.g. section 239 of the CBCA. If such leave is granted, consideration would have to be given to providing in the proposal, plan of arrangement or distribution order a mechanism by which the ultimate fruits of the action would be distributed according to the prescribed waterfall in the proceeding.

Another potential avenue would be the appointment pursuant to section 11 of the CCAA of representative counsel with a specified mandate to pursue a class claim on behalf of a particular constituency of stakeholders. This was done recently in the *League Assets* CCAA proceeding, where Fasken Martineau DuMoulin LLP was appointed representative council for certain investors in the debtor group of companies with a mandate to pursue directors, officers and trustee's liability claims, together with a mechanism by which its fees were to be paid by the debtor's estate.[50]

No matter which route is taken, some consideration will have to be given to the "other people's money" problem,[51] meaning the situation in which fees are incurred to the benefit of one group of stakeholders, but are actually paid by some other group of stakeholders that is on the equity bubble. It is likely that more often than not, the answer to that problem in the context of the bringing of derivative claims is for such claims to be pursued on a contingency fee basis or through third-party litigation funding. Otherwise, if a secured creditor is to bear the expense of pursuing a derivative claim that would benefit subordinate

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50 *League Assets Corp., Re*, 2013 CarswellBC 3408 (B.C. S.C.). Court documents available online: <www.pwc.com/ca/en/car/leagueassets/assets/leagueassets-029_10252013.pdf>.

51 See Cynthia A Baker, "Other People's Money: The Problem of Professional Fees in Bankruptcy" (1996) 38 Ariz L Rev 35.

constituencies, it will likely have to be shown that that secured creditor benefited from the conduct complained of.

7. CONCLUDING THOUGHTS

Every jurisdiction must strike its own balance between protecting vulnerable and unsuspecting creditors from the risks of corporate insolvency versus promoting entrepreneurial risk-taking and a "rescue" culture of corporate insolvency. At one extreme are the jurisdictions that provide direct liability against directors for trading while insolvent.[52] Canada arguably sits at the other extreme. While many insolvency professionals and lawyers counsel businesses against incurring further debt when they are facing formal insolvency, the Canadian approach to resolve and/or settle prior to litigate attitude vs. the U.S. approach of commencing litigation and settling or continuing with litigation may be depriving stakeholders, in certain cases, of potential recovery from the legitimate derivative claims against directors and officers, professional advisors and other third parties, that — as in *Livent* — increased the liquidation deficit of the corporation. The United States, while promoting a "rescue" culture of corporate insolvency, sits at a less extreme end of the spectrum given the frequency with which derivative claims are pursued there. Yet it can hardly be said the corporate entrepreneurialism and risk-taking are less vibrant in the United States than they are in Canada.

The approval of the damages model in the *Livent* litigation presents an opportunity to renovate our approach at a moment when economic forces have rendered unsecured creditors more vulnerable to total non-recovery than ever before. Given the proven fraudulent scheme, and professional obligations unmet by the defendant, that may be an isolated case. Or it may serve as a useful framework with which to evaluate and fund derivative claims in other situations as well.

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52 See e.g. *Corporations Act 2001* (Cth), s. 588.