A SECOND LOOK AT THE ONTARIO COURT OF APPEAL'S DECISION EXPANDING DIRECTORS' DUTIES

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McMillan LLP discussed the Ontario Court of Appeal's decision in *Extreme Venture Partners Fund I LP et al v Varma et al*[1] in an insight published earlier this year.[2] In *Varma*, the Court of Appeal held, in *dicta*, that the defendant directors of a corporate general partner of a limited partnership owed an *ad hoc* fiduciary duty to the limited partnership. In this article, we focus on why *Varma* may open the floodgates to claims from various corporate stakeholders against corporate directors.

We argue against employing an *ad hoc* fiduciary duty analysis to hold directors of any corporation liable to anyone other than the corporation. We suggest that a preferred route to holding directors responsible for a loss suffered indirectly by a corporate stakeholder involves the pursuit of a derivative action.

The Court of Appeal Expanded the Class of Stakeholders to Whom Directors' Fiduciary Duties are Typically Owed

In *Varma*, the directors of the corporate general partner acted in a manner resulting in losses to the limited partnership. The factual background of the case is available in our earlier article. One of the subsidiary issues on appeal was whether the directors who owed a duty to the corporate general partner could be held liable for losses suffered by the limited partnership. In *dicta*, the Ontario Court of Appeal considered the trial judge's statement that the directors owed a fiduciary duty only to the corporate general partner, not to the limited partnership itself.[3]

The trial judge's statement was consistent with well-established principles. It is trite law that, further to the rule in *Foss v Harbottle*, a shareholder of a corporation does not have a personal cause of action for a wrong done to the corporation. In particular, the breach of a duty owed to a corporation that indirectly impedes other stakeholders' ability to supervise the affairs of the corporation does not give rise to any right of those stakeholders opposite a party that falls short on its duty to the corporation.[4] Only the corporation, as a distinct legal entity, can sue for harm it has suffered.

The relationship between directors of a corporate general partner, on the one hand, and a limited partnership, on the other hand, is not one to which a fiduciary relationship is generally assigned. The directors of the

corporate general partner owe their duty to the corporate general partner. To the extent that that duty is breached, any cause of action lies in the hands of the corporate general partner further to the rule in *Foss v Harbottle*.

However, the Court of Appeal reviewed circumstances in which an *ad hoc* fiduciary duty of directors of a corporate general partner in favour of a limited partnership might be established on principles set out by the Supreme Court of Canada in *Frame v Smith*.[5] That case reviewed how an *ad hoc* fiduciary duty may be imposed where (i) a party may unilaterally exercise discretion affecting a beneficiary's legal or practical interests in (ii) circumstances where the beneficiary is peculiarly vulnerable to the party with the discretionary power.

In *Varma*, the Court of Appeal observed that the limited partners and limited partnership constituted a class of vulnerable and defined beneficiaries, whose legal and substantial practical interests stood to be adversely affected by the impugned directors' exercise of discretion.[6] Accordingly, the Court of Appeal determined that an *ad hoc* fiduciary duty ought to apply, and the limited partnership thus had a cause of action against the directors of the corporate general partner.

The issue with that analysis is that it could equally apply to any number of corporate stakeholders, including, for example, shareholders and bondholders, who suffer a loss because a corporation's directors fall short of satisfying their fiduciary duty *to the corporation*. Just as the limited partnership in *Varma* was vulnerable to the exercise of discretion of the directors of the general partner, shareholders and bondholders are vulnerable to the exercise of discretion of the directors of the corporation in which those shareholders and bondholders have an interest. Relying on the *dicta* in *Varma*, such stakeholders may now plead reliance on an *ad hoc* fiduciary duty whenever they purport to have been harmed by the conduct of directors of a corporation in which they have an interest.

A Different Route Was Available

The Court's motivation in *Varma* for the imposition of an *ad* hoc fiduciary duty appeared to stem from a perceived lack of remedy, outside of a contractual remedy, for the breach of a director's fiduciary duty owed to a corporate general partner where the limited partnership suffers loss. The Court was of the view that "it would be an anomalous result if the law offered no remedy for the breach of a director's fiduciary duty in circumstances where the limited partnership suffered the resulting loss."[7] The Court applied an *ad hoc* fiduciary duty to fill this purported gap. But the Court of Appeal arguably overlooked the use of the derivative action, which was well-suited to obtaining a remedy for the limited partnership in the circumstances.

In *Varma*, the direct cause of the limited partnership's loss was that the corporate general partner failed to protect the limited partnership's interests. The general partner permitted the dissemination of its confidential

investment strategy and participated in the improvident sale of one of the limited partnership's material investments. In the first instance, then, the limited partnership's complaint ought to have been directed at the general partner.

The challenge in pursuing such a complaint was that, as identified by the Court of Appeal in *Varma*, in a limited partnership structure the general partner directs the actions of the limited partnership,[8] and the general partner would not be inclined to sue itself. This challenge is resolved, however, using the common law derivative action. As recently reviewed in *Binscarth Holdings LP v Grant Anthony*,[9] the common law derivative action is available to minority limited partners where they can satisfy the court that the majority refused to pursue the proposed action, the proposed action is brought in good faith, and the action is prudent and in the limited partnership's interest. In *Varma*, aggrieved limited partners could have started by pursuing a common law derivative action against the corporate general partner in the name of the limited partnership.

A derivative action by the minority limited partners against the general partner in the name of the limited partnership would not, by itself, permit recovery from the directors of the general partner. The limited partnership's derivative action against the general partner could only result in direct recovery from the general partner. However, seeing as how the general partner's failures stemmed from breaches by the impugned directors of the fiduciary duty they owed to the general partner, the general partner would have a direct claim for contribution and indemnity against the impugned directors. But that potential claim for contribution and indemnity would run into the same problem as the limited partners had in causing the limited partnership to sue the corporate general partner. The impugned directors of the corporate general partner would not be inclined to have the corporate general partner pursue a claim against themselves.

Again, employing the machinery of the derivative action would be necessary. In particular, the limited partnership could have caused the corporate general partner to pursue its directors for contribution and indemnity by seeking leave to bring a derivative action further to section 246(1) of the *Business Corporations Act* (Ontario).[10]

Using this knock-on derivative action approach (i.e., first a derivative action for breach of fiduciary duty in the name of the limited partnership against the general partner, then a second derivative action in the name of the general partner against the impugned directors for contribution and indemnity grounded in those directors' breach of fiduciary duty), the same relief would have been available to the limited partnership and ultimately its limited partners without any need to rely on an *ad hoc* fiduciary duty.

Derivative Actions Should be Preferred

There are at least two reasons that, in *Varma*, knock-on derivative actions would have been preferable to entertaining the generation of an ad hoc fiduciary duty, and potentially opening the floodgates to similar

efforts at holding directors to account for losses incurred by parties other than the corporation. First, leave from the court is a prerequisite to any derivative action. Whether leave is sought to commence a common law or statutory derivative action, the complainant will be denied leave where they cannot satisfy the court that they are acting in good faith and that it is in the interests of the corporation to prosecute the action. Thus, the court serves as a gatekeeper for claims against directors and can stop unmeritorious claims before valuable corporate resources are spent.

Second, where leave is granted to bring a derivative action, and a statutory derivative action in particular, the court obtains broad discretion to grant any order it thinks fit.[11] A court might, for example, order that the corporation in whose name the derivative action is brought pay the reasonable fees and other costs reasonably incurred by the complainant in connection with the action. That may, in some cases, serve to level the playing field where the complaining minority have fewer resources than the impugned directors may have at their disposal.

The Supreme Court of Canada recently dismissed an application for leave to appeal *Varma*. While the preferred mode for limited partnerships to remedy wrongdoing of directors of a general partner of the limited partnership is an important issue for corporate law in Canada, the fact that it was a subsidiary issue at the Ontario Court of Appeal in *Varma* may have meant that the Supreme Court of Canada was less inclined to address it. The fact that the trial level decision was, aside from the quantum of the award, substantively untouched on appeal, may also have been a factor. In the circumstances, it may take a proliferation of claims against directors grounded in a purported *ad hoc* fiduciary duty to see whether other courts may look to more narrowly construe the Ontario Court of Appeal's analysis in *Varma* and encourage knock-on derivative actions.

[1] 2021 ONCA 853 [*Varma*].
[2] Caroline Samara and Sam Foster, "Fiduciary Duties in Corporate Transactions: Expansion of Director's Duties to Limited Partnerships & Liability of Knowing (Third Party) Assistants", February 2, 2022, McMillan LLP <online>.
[3] *Extreme Venture Partners Fund I LP et al v Varma et al*, 2019 ONSC 2907 at para 182; *Varma* at para 94.
[4] *Hercules Management Ltd v Ernst & Young*, 1997 CanLII 345 (SCC) at para 60.
[5] *Frame v Smith*, 1987 CanLII 74 (SCC); *Varma* at para 102.
[6] *Varma* at para 103.
[7] *Varma* at para 96.
[8] *Varma* at para 98.
[9] 2022 ONSC 3426.
[10] RSO 1990, c B 16, s. 246(1) [*OBCA*].
[11] See for example, *OBCA*, s. 247.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.