Directors' Liability

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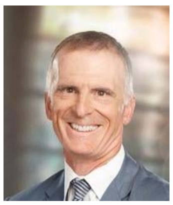
Authors



Luc Pariseau

Partner, Lawyer

Audrey Gibeault

Partner, Lawyer

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DIRECTORS' LIABILITY FOR PAYROLL WITHHOLDING TAXES

Luc Pariseau and Audrey Gibeault

Directors of a corporation may be held personally liable in cases where the corporation fails to withhold and remit federal or provincial payroll taxes on salary, wages and certain benefits. Directors may also be liable for amounts which ought to have been withheld on payments to a non-resident that are subject to withholdings under Part XIII of the *Income Tax Act*[1] (herein referred to as the «Act»). This article reviews in more detail the potential exposure that directors face, and also briefly describes some of the possible remedies that are available in such cases.

With respect to federal income taxes, the failure of a corporation to deduct, withhold or remit source deductions under the Act, the *Employment Insurance Act*[2] *or the Canada Pension Plan Act*[3] *subjects its directors to personal liability for the unpaid and unremitted amounts. A similar principle applies in the province of Quebec for an amount that an employer was required to deduct, withhold or remit under the Tax Administration Act*[4] *(hereinafter referred to as the "Administration Act"), the Act respecting the Québec Pension Plan,*[5] *the Act respecting parental insurance,*[6]*the Act respecting labour standards,*[7]*the Act to promote workforce skills development and recognition,*[8] *and the Act respecting the Régie de l'assurance maladie du Québec.*[9]

The purpose of these rules is to make the directors liable for the payment of the employer's contributions. Section 24.0.1 of the Administration Act and section 227.1 of the Act apply to directors holding office on the date on which the amounts were to be remitted, the date they were to be deducted, withheld or collected, and the date on which an amount was to be paid. In certain circumstances, a person not officially appointed as a director could be considered to be a "*de facto*" director and become liable if such person performs some of the functions that a director would normally perform.

Before a director becomes liable under these provisions, the tax authorities have to demonstrate that they cannot recover the amounts directly from the particular corporate taxpayer. Additionally, the tax authorities must register a certificate for the amount of the corporation's liability and establish that the amount remains unsatisfied. The director will need to establish that he exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.[10] The case law on this point[11] has shown that the issue is generally whether, at the relevant time, the director knew or ought to have known of the problem, and whether he took the action within his power under the circumstances to correct the situation.

In addition, the tax authorities cannot assess a director for source deductions owing after the expiry of two years from the date on which the director ceased to be a director of the corporation.[12]

Directors may require the corporation to purchase insurance on their behalf to protect them and former directors against liabilities incurred due to their status as directors, provided that they have fulfilled their fiduciary duties. Directors may, in particular, seek the advice of tax specialists to ensure that they comply with their obligations relating to payroll withholding taxes.

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1 R.S.C. 1985, c. 1 (5th Supp).
2 SC 1996, c. 23.
3 RSC 1985, c. C-8.
4 R.S.Q. c. A-6.002.
5 R.S.Q., c. R-9.
6 R.S.Q., c. A-29.011.
7 R.S.Q., c. N-1.1.
8 8 R.S.Q., c. D-8.3.
9 R.S.Q., c. R-5.
10 227.1(3) of the Act and 24.0.1 of the Administration Act.
11 *Soper* v. *Canada*, [1998] 1 C.F. 124 and *Peoples Department Stores Inc. (Trustee of)* v. *Wise*, [2004] C.S.C. 68.
12 227.1(4) of the Act and 24.0.2 of the Administration Act.

DUE DILIGENCE: AN EVOLVING STANDARD

Jean-Philippe Latreille and Emmanuel Sala

Nobody is held to the impossible. This maxim is reflected in statutes that hold directors of a corporation liable, on a solidary or joint and several basis, for its failure to comply with certain tax obligations. Indeed, directors will generally be relieved from such liability if they can demonstrate that they acted with a degree of care, diligence and skill that is reasonable under the circumstances. This is commonly known as the “due diligence defence.”

Naturally, the circumstances are specific to each case, and there are no hard and fast rules for determining whether a director can rely on the due diligence defence. We must therefore turn to the courts’ interpretation of this standard, which has fluctuated somewhat in recent years.

For many years, an “objective-subjective” test prevailed. This meant that directors had to show they had exercised the skill that can be expected from a person with the same level of knowledge or experience. The fact that the director’s personal abilities were taken into account made it possible to apply the standard of due diligence with some flexibility.

However, following the Supreme Court of Canada’s 2004 decision in *Peoples*,[1] courts have determined that the test for the due diligence defence should be objective, but must also include a consideration of the specific circumstances faced by the corporation and its directors.

Although all directors have the same duty of diligence, it should be noted that the analysis of a director’s liability must take into account the very different contexts in which “outside” and “inside” directors operate. Inside directors play an active role in the corporation’s management and can influence the conduct of its business affairs. They are in a better position to become aware of a corporation’s financial difficulties soon after they arise, and to take such corrective measures as are possible. The reality for outside directors is very different: most often, they are completely dependent on the information they receive from the corporation’s management and on the opinions expressed by experts (such as the corporation’s auditors) though this does not give them licence to disregard outward signs of financial difficulty.

Consequently, the distinction between outside and inside directors is a contextual factor to take into consideration as part of the “objective” analysis associated with the due diligence standard ordained by the Supreme Court. This means that instead of considering the skills, aptitudes or personal characteristics of a given director — an approach that would fit more closely with the “objective-subjective” analysis that used to prevail — one must consider the circumstances associated with the director’s role and position with the corporation.

Furthermore, the obligation which tax statutes impose on directors is an obligation of means, not an obligation of result. Thus, a director will not be held liable if he or she implemented measures that a reasonably prudent person would have taken, even if those measures did not yield the desired results. In this sense, directors cannot be regarded as unconditional guarantors of a corporation’s tax liabilities. For example, a director will not be held liable for the failures of an employee of the corporation if that employee had the necessary training and was appropriately supervised.

In conclusion, the decision to become a director of a corporation should not be taken lightly. Before accepting such an office, one should ensure that the corporation has sound governance practices in place and that these practices will be followed throughout one’s mandate. Directors should not hesitate to consult with their legal advisors in order to ensure that they act in accordance with their obligations and thereby limit their exposure to liability.

[1] *Peoples Department Stores Inc. (Trustee of)* v. *Wise*, [2004] xv3 SCR 461.

TO WHAT RISKS OF LIABILITY OR BEING FOUND GUILTY ARE

DIRECTORS EXPOSED?

André Laurin

Directors are subject to the legal liability regime provided in the incorporating statute of the legal person and possibly to that of its registered office and, in some respects, to the regimes in place in jurisdictions where the legal person carries out its activities. It is therefore important to have a good knowledge of the laws that apply to the legal person and directors. In the context of Quebec law, directors face two major types of potential liability, namely:

- contractual liability to the legal person of which they are directors or, by way of derivative action, to the persons who may step into the shoes of the legal person in certain circumstances (shareholders or creditors of the legal person); and
- extracontractual liability (delictual, quasi-delictual and penal) to third parties, but also to the legal person.

CONTRACTUAL LIABILITY

Civil contractual liability stems from the nature of the link between the legal person and its directors. Under Quebec law, directors are mandataries of the legal person. They may incur liability to the legal person if they do not discharge their duties (care and loyalty) to the legal person or if they exceed the limits of their mandate.

EXTRACONTRACTUAL LIABILITY

Extracontractual liability may be civil or penal in nature.

A person seeking a civil liability judgement is required to prove that the director, in the course of discharging its duties, committed a fault which caused damages to such person. However, the person may in some circumstances rely on legal liability presumptions against the director. The court will assess the elements put before it according to the rule of preponderance of evidence.

For instance, a director who would knowingly support the decision of the board to authorize the marketing of a product which he knows is hazardous or non-compliant with the regulatory standards of the industry and may cause damages to third parties may be ordered to pay damages to the victims who suffer such damages. In the same way, a director who votes in favour of a recommendation to the shareholders to approve a merger or accept a takeover bid which he knows or should have known that it is not fair or not in the interest of the legal person and its shareholders may be held liable to the shareholders.

Failure by a director to exercise its duty of care or duty of loyalty to the legal person may in certain circumstances be considered by the courts as being a civil fault in the context of proceedings against the director by the legal person itself or third parties.

Specific statutes identify certain behaviours as constituting penal or criminal offences. Some statutes also create presumptions of guilt. The evidence will be assessed on the basis of the “beyond a reasonable doubt” criterion. Furthermore, the *Criminal Code* (Canada)[1], mainly in section 21, opens the door to the concept of complicity to or participation in a criminal or penal offence. A director who is found guilty may, according to the case and the nature of the criminal offence, be ordered to pay a fine, be imposed a limitation of his rights and even imprisonment.

In most cases, a defence of due diligence may be made, even against a presumption, if the director has been in fact diligent. Furthermore, it is to be noted that the more the determination of the fault is objective, the less accessible becomes the defence of due diligence.

For a more detailed analysis of the duties of directors and the nature of their potential liability, please refer to the document entitled “The Corporate Director: Questions and Answers”.[2]

OTHER REMEDIES

The oppression remedy and the application for an injunction complete the arsenal of means or remedies which may be brought against directors.

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[1] Criminal Code (Canada) R.S.C. (1985), c. C-46.

[2] "The Corporate Director: Questions and Answers". lavery.ca/sme/corporate-governance.html

ENVIRONMENTAL LIABILITY OF DIRECTORS AND OFFICERS

Katia Opalka

Several federal and provincial statutes in force in Quebec make corporate directors and officers personally liable for offences of an environmental nature committed by the corporation. Corporations can face site assessment and clean-up orders. Subject to certain conditions, directors and officers of a corporation can be named to such orders. The environment ministry can also refuse to issue or renew environmental authorizations on the grounds that a director or officer of the corporation, of a related corporation, or of a lender of the corporation was found guilty of an offence or convicted on certain types of tax charges in the preceding five years. This article reviews sources of personal liability for directors and officers and then identifies measures that can be taken to manage these risks so that they don't become an obstacle to recruiting and retaining talented people.

Quebec's *Environment Quality Act* (EQA or the Act) creates a presumption: when a corporation is convicted of an offence under the Act, its directors and officers are presumed to be guilty of that offence unless they can show that they exercised due diligence and took all necessary precautions to prevent commission of the offence. In the case of a partnership, all the partners, except for special partners, are deemed to be directors of the partnership, unless they can show that one or more of them, or a third person, manages the affairs of the partnership. Where a director or officer commits an offence, the minimum and maximum amounts of the fines prescribed in the Act for individuals (min. $1,000/max. $1,000,000) are doubled. When a corporation defaults on payment of an amount owed to the Minister under the EQA or its regulations, the corporation's directors and officers are jointly and severally liable with the corporation for the payment of that amount, unless they can show that they exercised due care and diligence to prevent the breach which led to the claim.

With respect to site assessment and clean-up orders, directors and officers may be the subject of such an order if they have had custody or control of the site, unless they can show that either:

1. they were unaware of and had no reason to suspect the presence of contaminants in the land, having regard to the circumstances, practices and duty of care;
2. once they became aware of the presence of contaminants in the land, they acted in conformity with the law, as to the custody of the land, in particular as regards the duty of care and diligence; or
3. the presence of contaminants in the land is a result of outside migration from a source attributable to a third person.

To guard against the risk of environmental liability, corporate directors and officers should make sure that the corporation has an environmental management system that works. They should also consider whether it would be worthwhile to take out pollution insurance, to address risks that are not normally covered in directors' and officers' liability insurance policies.