

# Directors' and officers' liability: Recent developments, updates and best practices

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## Overview

- **Background**
  - Corporate
  - Tax –
    - Tax liability?
    - Technical requirements
    - Due diligence
- **Recent case law**
  - Corporate cases
  - Tax – Resignations, de facto directors, fraud
- **Best practices**
  - Corporate
  - Tax

# Background corporate

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## Discussion of legal duties

- Legal duties
- Recent case law
- Best practices

## Legal duties

- Corporate law
- Securities
- Tax law
- Employment law
- Environmental law
- *Rules of professional conduct*
- Other legislation

## Corporate Law – duty to the firm

- Directors and officers have two distinct duties at all times:
  - Fiduciary duty
  - Duty of care and diligence
- CBCA 122(1): Every director and officer of a corporation in exercising their powers and discharging their duties shall
  - (a) **act honestly and in good faith** with a view to the **best interests of the corporation**; and
  - (b) exercise the **care, diligence and skill** that a **reasonably prudent person** would exercise in **comparable circumstances**.

## Corporate law – fiduciary duty

- “...act honestly and in good faith with a view to the **best interests of the corporation**” (CBCA 122(1)(a))
- As fiduciaries of the corporation, directors and officers must “**serve the corporation selflessly, honestly and loyally**”
- *Peoples Department Stores Inc*, 2004 SCC 68, [2004] 3 S.C.R. 461
- Fiduciary duties of directors and officers are to the corporation. And yet...
- *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69, [2008] 3 S.C.R. 560

## Corporate law – Duty of care

- “...exercise the **care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances**” (CBCA 122(1)(b))
- A director:
  - must **act honestly**
  - must exhibit the skill that may **reasonably be expected of a person of his knowledge and experience**
  - is **not liable for mere errors in judgment**
  - is **justified**, in the absence of suspicion, in delegating certain tasks to an officer of the company
- *Peoples Department Stores Ltd (1992) Inc Re*, 2004 SCC 68, [2004] 3 S.C.R. 461
- *City Equitable Fire Insurance Co., Re* [1925] 1 Ch 407 (CA)

## Corporate law – selected statutory highlights

- Personal liability for directors/officers who:
  - knowingly authorize, permit or acquiesce in the wrongful transfer of shares by a corporation (CBCA 32(4));
  - vote for or consent to a resolution authorizing issuance of shares for non-monetary consideration below fair value (CBCA 118(1));
  - vote for or consent to a resolution improperly purchasing shares, paying a commission, paying a dividend, granting financial assistance, providing an indemnity or making certain payments to a shareholder (CBCA 118(2));
  - knowingly authorize, permit, or acquiesce in the corporation's failure to give notice of a meeting of shareholders or failure to adhere to proper protocols for soliciting and preparing proxies, including sending proper forms of proxies (CBCA 149(4) and 150(4));
  - fail to comply with requirements to notify the audit committee and the auditor of financial statement errors or misstatements and failure to prepare and issue revised statements and notify shareholders if the errors or misstatements are material (CBCA 171);
  - fail to provide the Director (under the CBCA) with information concerning rights in securities (CBCA 235(5));
  - make or assist in making a report, return, notice, etc. required by the CBCA that includes untrue statements or omits material facts (CBCA 250); and
  - contravene the CBCA or its regulations (CBCA 251).

## Securities law

- Some offences that directors and officers may commit under the *Securities Act* (Ontario) that could result in personal liability include:
  - **misrepresentations** in a prospectus (130)(1)(c);
  - **misrepresentations** in a circular or notice (131(1)(a), 131(2));
  - **misrepresentations** in a prescribed disclosure document such as a material change report (138.3(1)(b), (c), (d));
  - **misrepresentations** in public oral statements (138.3(2)(c), (d))
  - insider **trading, tipping** and **recommending** (76);
  - failure to make **timely disclosure** (138.3(4)(b), (c));
  - permission or acquiescing with **noncompliance** with the act (129.2); and
  - making a misleading or **untrue statement** to the Commission or Director (126.2)
- Insider trading, including tipping, is also prohibited by CBCA 130 and 131

## Employment

- A director is liable for:
  - up to **6 months' wages of employees** in certain circumstances (CBCA 119, Canada Labour Code 251.18, *Employment Standards Act*, 2000 81);
  - **occupational health and safety violations** by federal public service (Canada Labour Code 149(2)(a));
  - **non-payment of wages** or other amounts (Canada Labour Code 251.1);
  - **offences** under the *Employment Insurance Act* (39(3), 46.1, 83, 107, 125(17)); and
  - **failure to comply** with an order of an employment standards officer or of the Labour Relations Board (*Employment Standards Act*, 2000 136(1))
- Personal liability may result if the Canada Employment Insurance Commission becomes aware of facts that in its opinion establish that the employer or other person has, among other things,
  - made a **false or misleading representation** known to the employer or other person (*Employment Insurance Act* 39(1)(a));
  - provided **false or misleading information** known to the employer or other person (*Employment Insurance Act* 39(1)(b));
  - made a **false or misleading declaration** because of the non-disclosure of facts known to the employer or other person (*Employment Insurance Act* 39(1)(c));
  - **defrauded or deceived** the Commission (39(1)(d)); or
  - participated in, assented to or **acquiesced** in the above (39(1)(e));

## Environment – federal

- *Canadian Environmental Protection Act* 280(1) imposes liability on directors and officers for offences committed by the corporation.
- Liability follows if the director or officer **directed, authorized, assented to, acquiesced in or participated** in the commission of the offence, whether or not the corporation has been prosecuted or convicted.
- *Canadian Environmental Protection Act* 280.3(1) and (3) imposes liability on directors and officers of corporate ship owners.

## Environment – provincial

- *Environmental Protection Act (Ontario) 194(1):*

Every director or officer of a corporation has a duty to take all reasonable care to prevent the corporation from discharging or causing or permitting the discharge of a contaminant and failing to notify the Ministry of a discharge of a contaminant under:

- the EPA
- the regulations
- an environmental compliance approval, certificate of property use, renewable energy approval, licence or permit under the EPA.

Failure to carry out this duty is an offence (194(2)).

## The good news...

- Defences exist to claims of director and officer liability.
- These often include due diligence.

## The bad news...

- Directors can be held personally liable.
- Usually, this liability is financial, but it may include jail time.
- Ignorance is not a defence.
- Resignation is not necessarily a defence.
- Board indemnity may not be enough.
- Directors may be liable for nonperformance.
- Sometimes shareholders are *de facto* directors.

## Directors' liability for unpaid payroll/corporate taxes and GST/HST

## Directors' liability for unpaid corporate taxes & gst/hst

- Examples
- Tax Liability?
- Technical Requirements
- Due Diligence

## Directors' liability for tax

- Examples:
  - Corporation is having cash flow problems. Dips into GST/HST collections to meet obligations to other creditors (for example, payroll).
  - Corporation has properly deducted and remitted employee portion of CCP/EI obligations. New payroll clerk inadvertently failed to meet employer's obligations.
  - Corporation hired an independent contractor.
- *Deakin v. The Queen*, 2012 TCC 270
  - [24] ... if a corporation and its directors choose to unilaterally "borrow" from Canadian taxpayers and the public purse, Canadians get the benefit of security akin to personal guarantees of the directors.

## Directors' liability for tax – Overview

- For which taxes may a director be liable?
  - Employee source deductions
  - CPP, EI
  - Non-resident withholding tax
  - GST/HST
  - Ontario PST
  - Many other taxation statutes
- Generally, directors are not liable for the corporation's unpaid income tax liability
- May be assessed if corporate assets were transferred to the directors in certain circumstances:
  - As a shareholder?
  - As an employee?

## Directors' liability for tax – Overview

- Who may be liable?
- What is a "director"?
- What is a director's statutory duty? (OBCA, CBCA)
- Ceasing to be a director
- Failure
- Execution/Collections
- Time Limits
- Defenses

## Directors' liability for tax – Technical requirements

- Failure
  - Where a corporation has failed to ... (*Income Tax Act*, s. 227.1)
  - Where an employer fails to deduct or remit an amount ... (*Canada Pension Plan*, s. 21.1)
  - Where an employer fails to deduct or remit an amount ... (*Employment Insurance Act*, s. 83)
  - If a corporation fails to remit ... (*Excise Tax Act*, s. 323)
  - Where a corporation has failed to ... (Ontario *RST Act*, s. 43)

*... the directors of the corporation at the time ... are jointly and severally liable with the corporation to pay the amount and any interest or penalties relating to the amount ...*

## Directors' liability for tax – Technical requirements

- Execution/collection
- A director is not liable unless
  - A certificate for amount of corporate liability is registered in Federal Court and execution returned unsatisfied, or
  - The corporation has commenced liquidation or dissolution, or
  - The corporation has made an assignment in bankruptcy.

- A director's liability "does not crystallize until the conditions prescribed in subsection 227.1(2) have been satisfied" – *Worrell v. The Queen*, 2000 DTC 6593
  - Evidence?
  - Steps to collect?

## Directors' liability for tax – Technical requirements

- Time Limits
  - No action or proceeding to recover any amount payable by a director may be commenced more than two years after the director last ceased to be a director of the corporation.
- When does clock start running?
- Effective resignation?
  - RPC s. 3.1-2

## Directors' liability for tax – Defenses

- Procedure / Onus of Proof
  - Assessment (collections)
  - Objection / Appeal
- Defenses
  - Was the individual a director?
  - Has director's liability "crystallized"?
  - Have technical requirements been met?
  - Time limit on assessment?
  - Apportionment of liability?
  - Correctness of underlying corporate assessment?
  - Due diligence?

## Directors' liability for tax – Due diligence

- Due diligence defense:
  - A statutory defense against an otherwise valid assessment of directors' liability
  - Individual not personally liable 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".
    - *Income Tax Act*, s. 227.1(3)
    - *Excise Tax Act*, s. 323(3)
    - Other statutes have the same defense

## Directors' liability for tax – Due diligence

- Courts have held that the standard is an objective test
- Development of the applicable standard:
  - *Soper v. The Queen*, 97 DTC 5407
  - *People's Department Stores Inc. v. Wise*, 2004 SCC 68
  - *Buckingham v. The Queen*, 2011 FCA 142
- *Buckingham* :
  - Director was assessed as a director for unpaid GST/HST, interest and penalties
  - There were also assessments for unremitted source deductions, CPP/EI and under various provincial statutes
  - Courts concluded that the appropriate test is an objective standard
  - No subjective element to the test
  - "Inside" v. "outside" director concept still relevant in applying standard

## Directors' liability for tax – Due diligence

- *Buckingham* –
  - Assessment of the director's duties begins when financial difficulties are “reasonably apparent”, not just when the cash flow stops
  - Requires efforts to prevent the failure to remit
  - Not sufficient to simply make efforts to cure the defaults in past remittances

Directors' liability not absolute – possible that corporation will fail to make remittances without joint and several liability of its directors being engaged

## Recent developments Corporate

## Discussion of recent case law

- Legal duties
- **Recent case law**
- Best practices

## Current cases to consider – Piercing the Veil

### *Re Nortel*

- Nortel announced it would shut down its Western Innovation Centre (Calgary) after the expiration of a transition period.
- Nortel advised its Calgary employees it would make severance payments, but only if they worked until the stop-work date.
- Nortel would determine the stop-work date.
- In CCAA proceedings, some Calgary employees moved for an order imposing personal liability on the former directors of Nortel for severance payments (CBCA 119).
- Directors opposed the motion, arguing they were not liable under CBCA 119 because they exercised due diligence.

## Nortel

- Motion dismissed.
- Severance payments were to be paid in accordance with Nortel's past practices and were not a new payment to compensate Calgary employees for continuing to work at Nortel until the termination date.
- Since the payments were not for services performed for Nortel (as opposed to retention bonuses), they were not covered by the directors' liability language in CBCA 119.
- Directors relied on the legal and restructuring advice they received from a law firm engaged as independent counsel to Nortel's board in order to protect the directors from personal liability.

## Nortel

- "In my view of it, the Nortel directors were entitled to rely upon the legal and restructuring advice they received. They did so in good faith. It was not required of them to second guess the advice given by these leading professional firms. To have done so would likely have been perceived to be not acting prudently."

## Current cases to consider – Piercing the Veil *Ontario Chrysler Jeep Dodge*

- Gray was the majority shareholder, president and director of the corporation that operated a car dealership.
- Delisle managed the body shop.
- Delisle was dismissed, for cause: allegedly sexually assaulted an employee, vandalized the property of that employee's spouse and another employee, and carried on a side business from company premises repairing cars for cash.
- Ontario Chrysler sued Delisle; Delisle counterclaimed against Ontario Chrysler, Gray, the employee he allegedly assaulted, and others, alleging defamation and interference with employment.
- Gray moved for an order dismissing the counterclaim against him.

## *Ontario Chrysler Jeep Dodge*

- Motion was granted, there was no genuine issue requiring trial. The counterclaim contained no claims against Gray personally, but only claims in the corporate capacity vis a vis Ontario Chrysler.
- Gray fired Delisle on behalf of Ontario Chrysler; not in a personal capacity.
- “Only exceptional cases involving flagrant injustice warrant piercing the corporate veil.”
- Typically, the corporate veil is pierced if:
  - The corporation is incorporated for an illegal, fraudulent or improper purpose.
  - At the time of incorporation those in control expressly direct a wrongful thing to be done.
- No evidence that Gray was shielding himself behind Ontario Chrysler, or that it was being used for personal gain/to perpetrate wrongdoing.

# Recent developments

## Tax

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### Directors' liability for tax – Recent developments

- Due diligence defense
- Insurance
- Resignation – Timing?
- *De jure* or *de facto* director?
  - Case Study: A Tale of Two Directors (*MacDonald* and *McDonald*)
- Fraud and the due diligence defense

## Recent developments – Due diligence defense

- Due diligence
- *Deakin v. The Queen* (2012 TCC 270)
- *Constantin v. The Queen* (2012 TCC 425)
- *Martin v. The Queen* (2012 TCC 239)
- *Thistle v. The Queen* (2015 TCC 149)

## Recent developments – Insurance

- All D&O policies contain an exclusion for major personal misconduct such as fraud, other criminal activity, or willful breach of a statute or regulation
- Many policies state expressly whether statutory claims for taxes or wages are or are not covered, often in the definition of covered loss
- Policies typically do not provide coverage for fines or penalties

## Recent developments - Resignations

- Resignation – Timing?
- *Doncaster v. The Queen* (2015 TCC 127)
- *Chriss / Gariepy v. The Queen* (2016 FCA 236)

## Recent developments – *De Facto* Directors

- *De jure* or *de facto* director?
- *MacDonald v. The Queen* (2014 TCC 308)
  - Held: Not a *de facto* director
- *McDonald v. The Queen* (2014 TCC 315)
  - Held: *De facto* director

## Recent developments – Fraud

- Fraud and the due diligence defense
- *Roitelman v. The Queen* (2014 TCC 139)
- *Babakaiff v. The Queen* (2012 TCC 22)
- *Kaur v. The Queen* (2013 TCC 227)
- *Labrecque v. The Queen* (2012 TCC 339)

## Best practices Corporate

## Discussion of best practices

- Legal duties
- Recent case law
- **Best practices**

## Some key questions to consider

- Jurisdiction of incorporation
- Any indemnification of directors and officers
- Purchase of D&O insurance by the organization
- Independent chairman

## Performance of duties

- 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 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 (including dissent sent after the conclusion of a meeting).
- 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.
- Take active steps to inquire into the state of affairs of the corporation and communicate regularly with staff.
- Obtain independent legal advice when necessary.

## Mitigate risk, as applicable

- Insurance is like a parachute...if you don't have it when you need it, you'll never need it again.
- Best practices for assessing the adequacy of insurance:
  - Review potential areas of liability.
  - Appreciate your "risk appetite".
  - Determine who is covered by the policy.
  - Determine what risks are covered.
  - Determine what is carved-out or excluded from the policy.
  - Determine the length of coverage.
  - Settle any ambiguity in the contract and reduce intention into writing.
  - Compare the policy against existing indemnities (e.g. in employment contracts or by-laws).

## Avoiding or minimizing liability

### Due diligence

- Directors and officers can sometimes find protection from liability through the due diligence defence
- Due diligence provides protection where a director or officer can demonstrate that he or she acted diligently or took all the reasonable care in attending to the requirements of the corporation.
- Although the specific words used vary from statute to statute, the due diligence defence is often incorporated into the legislation.
- As a defence, due diligence is not always available:
  - absolute liability offences
  - administrative penalties
- Directors may be held liable for the acts of a corporation consented to by the board. Those directors who are present at a meeting are deemed to have consented unless their dissent is recorded in the minutes of the meeting and is provided to the corporation promptly after the meeting. (CBCA. 123(1))

## Best practices

### Tax

## Directors' liability for taxes – Best practices

- Do not bury head in sand!
- Understand scope of potential liability under various tax statutes
  - Seek counsel / legal advice if necessary
- Ask questions before joining board
  - Current financial systems?
  - Corporate financial health?
  - Previous failures?
- Keep own detailed records of inquiries / diligence, insist that certain deliberations / decisions captured in corporate minutes
- Propose director's resolution(s) regarding banking, remittances and financial reporting

## Directors' liability for taxes – Best practices

- Ask for regular financial reports and confirmation that tax accounts are current
- If failure, take both corrective and preventative actions
- Resign effectively – see Chriss / Gariepy FCA case!
- Lawyers acting as directors / advisors
  - *RPC: 3.2-7 / 3.2-8 – no fraud!*

## Questions?



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