



SURVEY OF LIABILITY OF DIRECTORS AND OFFICERS

This article provides a general survey of the possible liability of directors and officers of Ontario companies based on general legal principles and broadly-applicable statutes (as of November 2002). Where appropriate, we have also indicated possible steps to help limit exposure to directors and officers liability. These suggested steps are in addition to such possible steps as: making a unanimous shareholder declaration limiting the powers of the directors, purchasing directors and officers liability insurance and/or indemnifying the applicable directors and officers.

This article is broken into five main parts discussing director and officer liability: 1) to the corporation; 2) to employees (*i.e.*, wages); 3) to the government (*e.g.*, source deductions); 4) to other creditors; and 5) based on other sources. Generally, directors and officers owe duties to the corporation to act honestly and in good faith, and to exercise a certain standard of care when discharging their duties. Over and above this duty, directors and officers are potentially liable for such things as wages, pension benefits, vacation pay, source deductions, sales tax and under statutes such as the Competition Act or various environmental statutes. As a result of these numerous potential liabilities, it is incumbent on directors and officers to be duly diligent of their company's activities and to ensure that the proper company procedures and safeguards are in place.

1. LIABILITY TO THE CORPORATION

1.1 Duty of Good Faith and Care

It is a basic tenet of Ontario corporations law that directors and officers operate loyally and in good faith. Section 122(1) of the *Canada Business Corporations Act* ("**CBCA**")¹ outlines the fiduciary duty and standard of care required from directors and officers:

"Every director and officer of a corporation in exercising his powers and discharging his duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

¹ R.S.C. 1985, c. C-44.

The jurisprudence interpreting this section has recognized specific duties as being included in the general fiduciary standard.

However, there is a reasonable diligence defence for directors under section 123(4), discussed below.

Suggested action – Take steps to establish reasonable diligence under section 123(4) and have these recorded in the minutes of any applicable board meeting.

1.2 Compliance with Corporate Statute and Constatng Documents

Under section 122(2) of the CBCA:

“Every director and officer of a corporation shall comply with the Act, the regulations, articles, by-laws and any unanimous shareholder agreement.”

However, there is a reasonable diligence defence for directors under section 123(4), discussed below.

Suggested action – Take steps to establish reasonable diligence under section 123(4) and have these recorded in the minutes of any applicable board meeting.

1.3 Statutory Liability for Financial Distributions

Under section 118 of the CBCA, directors could be jointly and severally liable when voting for or consenting to a resolution authorizing an action that would have an adverse effect on the financial position of the corporation. Examples of such actions include: issuing shares for inadequate non-cash consideration; and declaring a dividend or authorizing a direct payment to purchase, redeem or acquire the corporation’s own shares if such acts place the solvency of the corporation in jeopardy.

However, there is a reasonable diligence defence under section 123(4), discussed below.

Suggested action – Take steps to establish reasonable diligence under section 123(4) and have these recorded in the minutes of any applicable board meeting.

1.4 Enforcing Directors’ Duties

(a) Oppression Remedy

This broad remedy, as it relates to directors, is set out in section 241(2) of the CBCA:

“If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates

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(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised **in a manner that is oppressive or unfairly prejudicial to or unfairly disregards the interests of any security holder, creditor, director or officer**, the court may make an order to rectify the matters complained of. (emphasis added)”

The court may make an order compensating any aggrieved person or order the replacement of the director(s).²

(b) Derivative Actions

Derivative actions permit shareholders to seek redress on behalf of the corporation for breaches of duties owed by the directors to the corporation.³

1.5 Defences

(a) Statutory Defence

Directors can rely on a reasonable diligence defence under section 123(4) of the CBCA, which reads:

“A director is not liable under section 118, 119 or 122 if he relies on good faith on

(a) financial statements of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or

(b) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him.”

(b) Business Judgment Rule

The business judgment rule is a rebuttable presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that it was in the best interests of the corporation.

2. LIABILITY TO EMPLOYEES

The largest area of potential liability for directors and officers is employee compensation.

2.1 CBCA

Section 119(1) of the CBCA reads:

“Directors of a corporation are **jointly and severally liable to the employees of the corporation for all debts not exceeding six months**

² CBCA, *supra* note 1, s. 241(3).

³ CBCA, *supra* note 1, s. 239.

wages payable to each such employee for services performed for the corporation while they are such directors respectively." (emphasis added)⁴

However, there is a reasonable diligence defence under section 123(4), discussed above.

Suggested action – Take steps to establish reasonable diligence under section 123(4) and have these recorded in the minutes of any applicable board meeting.

2.2 Employment Standards Legislation

Director liability under the *Employment Standards Act* (Ontario)⁵ is similar to liability under the CBCA and is set out under section 81(7):

"The directors of an employer corporation are **jointly and severally liable to the employees of the corporation for all debts not exceeding six months' wages**, as described in subsection (3), that become payable while they are directors for services performed for the corporation **and for the vacation pay accrued while they are directors for not more than 12 months under this Act** and the regulations made under it or under any collective agreement made by the corporation.⁶ (emphasis added)

Suggested Actions – (1) Trust Account - Since most companies payroll is distributed every 2 weeks, the maximum wage liability for directors is 2 weeks worth of past employee wages. (Directors are only liable for wages while they are directors and any future liability can be prevented by resignation.) In addition, directors are liable for a maximum of 12 months vacation pay under the ESA. As such, it would be advisable to establish a trust account with a balance of approximately 2 weeks gross wages plus 12 months vacation pay for the employees of the corporation. (2) Payroll Service - It may also be advisable to outsource the corporation's payroll function, if this is not already done, to a third party to insulate the directors from liability by ensuring that money is paid when it is available.

2.3 Pension Benefits

The *Pension Benefits Act* (Ontario)⁷ (the "**PBA**") establishes minimum standards for Ontario pension plans. Section 109(1) of the PBA reads: "Every person who contravenes this Act or the regulations is guilty of an offence."⁸

⁴ For directors to be exposed to liability, an unsuccessful claim against the corporation must have been brought within 6 months of the debt becoming due. The corporation must also have begun liquidation/dissolution proceedings, or an assignment or receiving order must have been made against it.

⁵ S.O. 2000, c.41.

⁶ As with director liability for unpaid wages under the CBCA, *supra* note 4, there are conditions precedent under section 81(1) of the ESA including that the employer must be insolvent and the employee has filed an unpaid claim with the court-appointed receiver or trustee, or that an employment standards officer has made an order that the employer is liable for wages.

The definition of "director" includes a shareholder that is party to an unanimous shareholder agreement under which the directors are relieved of their liability to pay wages under section 146(5) of the CBCA.

⁷ R.S.O. 1990, c. P.8.

⁸ Subsections 110(1), (2) and (3) of the PBA read:

An employer who receives or withholds money from an employee for payment into a pension plan holds those funds in trust.⁹ An employer also holds in trust any funds that the employer must contribute to the plan.¹⁰

In addition to fines, if a person is convicted of an offence relating to the failure to submit or make contributions to a pension fund, the court may order the person to pay the amount due to the fund.¹¹ An order for payment of an amount due to the fund may be filed with the Ontario Court (General Division) and enforced as an order of that court.¹²

Section 110(6) establishes a five-year statutory limitation on commencing a prosecution for an offence under the PBA.

In most cases, directors and officers have been convicted under the PBA for failing to file plan amendments, Annual Information Returns (AIRs), actuarial valuation reports and financial statements and failing to make or remit required contributions to a pension plan. Directors and officers have also been convicted under the PBA for failing to abide by the restrictions on the investment of pension plan assets provided under the PBA.¹³

2.4 Termination Pay

An employee, as a creditor, may also invoke the “oppression remedy” to render the directors of the employer corporation personally liable for severance or termination pay.

3. LIABILITY TO GOVERNMENT

Directors and officers liability to government include employee compensation-related source deductions and commodity taxes.

(1) Every person who is guilty of an offence under this Act is liable on conviction to a fine of not more than \$100,000 for the first conviction and not more than \$200,000 for each subsequent conviction.

(2) Every director, officer, official or agent of a corporation and every person acting in a similar capacity or performing similar functions in an unincorporated association is guilty of an offence if the person,

causes, authorizes, permits, acquiesces or participates in the commission of an offence referred to in section 109 by the corporation or unincorporated association; or

fails to take all reasonable care in the circumstances to prevent the corporation or unincorporated association from committing an offence referred to in section 109.

(3) A person who is guilty of an offence described in subsection (2) is liable on a first conviction to a fine of not more than \$100,000, and on each subsequent conviction to a fine of not more than \$200,000, whether or not the corporation or unincorporated association has been prosecuted for or convicted of an offence arising from the same facts or circumstances.

⁹ PBA, *supra* note 7, s. 57(1), (2).

¹⁰ PBA, *supra* note 7, s. 57(3).

¹¹ PBA, *supra* note 7, s. 110(4).

¹² PBA, *supra* note 7, s. 100(5).

¹³ In one case, directors and officers were convicted for allowing the pension fund to have a portfolio consisting of shares in the employer exceeding the maximum limit under the PBA.

3.1 Liability for Employee Obligations

(a) Federal and Ontario Income Tax

A director may be liable under the *Income Tax Act* (Canada)¹⁴ (the "**Federal Act**") and the *Income Tax Act* (Ontario) (the "**Ontario Act**")¹⁵ for prescribed deductions and withholdings from his corporation's employees' remuneration.

Section 227.1(1) of the Federal Act imposes liability on a director of a corporation which fails to withhold federal income taxes:

"Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or section 153 or 215, has failed to remit such an amount or has failed to pay amount of tax for a taxation year as required under Part VII or VIII, **the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally liable, together with the corporation, to pay that amount** and any interest or penalties relating thereto." (emphasis added)

The Ontario Act, under section 38(1), imposes liability on a director of a corporation which fails to withhold taxes:

"Where a corporation has failed to deduct or withhold an amount as required by subsection 153 (1) of the Federal Act, as it applies for the purposes of this Act, or has failed to remit such amount, **the directors of the corporation at the time the corporation was required to deduct or withhold the amount, or remit the amount, are jointly and severally liable**, together with the corporation, **to pay any amount that the corporation is liable to pay under this Act** in respect of that amount, including any interest or penalties related thereto. (emphasis added)"

Due Diligence Defence: Statutory defences are set out in section 227.1(3) of the Federal Act and section 38(3) of the Ontario Act and read:

"A director is not liable for a failure described under subsection (1) if the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances."

Note that the CCRA's published position is that a due diligence defence requires directors to take positive steps to ensure that the corporation makes the required remittances.

Suggested Action – Ensure that this issue is raised and recorded in the minutes to board meetings.

¹⁴ R.S.C. 1985, C. 1.

¹⁵ R.S.O. 1990, c.1.2.

Officer and Director Convictions: Under section 242 of the Federal Act or section 46 of the Ontario Act, officers and directors are subject to conviction for a corporation's offence if they are found to have: **"directed, authorized, assented to, acquiesced in or participated in"** the commission of an offence under the respective pieces of legislation.

(b) Employment Insurance

Under section 83(1) of the *Employment Insurance Act* (Canada) (the "**EIA**"), directors are liable for unremitted employment insurance amounts:¹⁶

"If an employer who fails to deduct or remit an amount as and when required under subsection 82(1) is a corporation, **the persons who were the directors of the corporation at the time when the failure occurred are jointly and severally liable**, together with the corporation, **to pay Her Majesty that amount** and any related interest or penalties." (emphasis added)

Officer and Director Convictions: Under section 107 of the EIA, officers and directors are subject to conviction if they are found to have: "directed, authorized, assented to, acquiesced in or participated in the commission of the offence."

(c) Canada Pension Plan

Analogous liabilities are also imposed under section 21.11(1) of the Canada Pension Plan¹⁷ for unremitted contributions.

"Where an employer who fails to deduct or remit an amount as and when required under subsection 21(1) is a corporation, **the persons who were the directors of the corporation at the time when the failure occurred are jointly and severally liable, together with the corporation, to pay to Her Majesty that amount and any interest or penalties relating thereto.**" (emphasis added)

By reference, directors can rely on the due diligence defence of section 227.1(3) of the Federal Act (outlined in Section 3.1(a) of this article).

(d) Non-Resident Income Tax

A director may also be rendered liable for not withholding and remitting tax on income from Canada of non-resident persons under section 215 of the Federal Act.

Suggested Actions – (1) Trust account - If a trust fund is established as suggested in Section 2 of this article with a constant balance of approximately 2 weeks gross wages (plus vacation pay), the deductions and withholdings that the corporation must remit to various governmental authorities will be

¹⁶ R.S.C. 1996, c.23.

¹⁷ R.S.C. 1985, Chap. C-8.

set aside and available for remittance. The net wages will then be available to satisfy any employee claims. (2) Payroll service - Once again, outsourcing the corporation's payroll function to a third party would help insulate directors from liability by ensuring that money is paid when it is available.

3.2 Liability for Customer Obligations

(a) Goods and Services Tax ("GST") and Retail Sales Tax

Although paid by the purchaser, the GST levied under the *Excise Tax Act*¹⁸ (the "ETA") is generally collected and remitted by the vendor of the goods, services or real estate. Liability for unremitted GST is set out in section 323(1) of the ETA:

"Where a corporation fails to remit an amount of net tax as required under subsection 228(2) or (2.3), **the directors of the corporation at the time the corporation was required to remit the amount are jointly and severally liable**, together with the corporation, **to pay that amount** and any interest thereon or penalties relating thereto." (emphasis added)

If provincial retail sales tax ("PST") is charged in a business' day-to-day operations, an analogous liability would arise where the corporation fails to collect and remit tax pursuant to section 43(1) of the *Retail Sales Tax Act*¹⁹ (the "RSTA"):

"Where a corporation has failed to collect tax or has collected tax and failed to remit the tax or has failed to pay any interest or penalty relating thereto, **the directors of the corporation at the time the corporation was required to collect or remit the taxes or to pay the interest or penalty relating thereto, are jointly and severally liable**, together with the corporation **to pay such amounts**." (emphasis added)

Due Diligence Defence: Statutory due diligence defences are set out in section 323(3) of the ETA and section 43(3) of the RSTA and read:

"A director of a corporation is not liable for a failure under subsection (1) 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."

Suggested Action – Ensure that this issue is raised and recorded in the minutes to the board meetings.

Officer and Director Convictions: Under section 330 of the ETA and section 107 of the RSTA, officers and directors are subject to conviction if they are found to have: "directed, authorized, assented to, acquiesced in or

¹⁸ R.S.C. 1985, C. E-13.

¹⁹ R.S.O. 1990, c. R.31.

participated in the commission" of an offence under the respective pieces of legislation.

Suggested Action - Similar to the trust account implemented for employee wages and source deductions, it would be advisable to have funds put aside for GST and PST remittances. This could be done by determining the corporation's historical (and projecting future) tax liability based on the corporation's reporting period. This calculated amount could then be put aside for use if, and when, necessary.

3.3 Liability for Corporate Obligations

(a) Oppression Remedy Available to Government

Since it has been determined by the courts that various governmental agencies are "complainants" for the purposes of the oppression remedy, directors may be liable where the interests of the government as a creditor are compromised.²⁰

(b) Director as Liquidator

A director may also be rendered liable for income taxes where he acts in the capacity of liquidator, receiver-manager or other like person who administers, winds up, controls or otherwise deals with the property, business or estate of the corporation.²¹ Liability is a possibility if certificates of compliances are not obtained from the Minister of National Revenue (Canada) and the Minister of Finance (Ontario) stating that all amounts owing under the Federal Act (for which he may be liable) have been paid or security has been accepted.

(c) Liability for Corporate Income Taxes

When Corporation Fails to File A Tax Return: Where a director or officer of a corporation has directed, authorized, assented to, acquiesced in or participated in the failure of the corporation to file a tax return, the director or officer may be guilty of an offence and be subject to the same fines and penalties as would apply to the corporation in respect of such failure, namely: (a) a federal fine of up to \$25,000 and a provincial fine of \$200 per day that the return is outstanding; and (b) imprisonment for a period of up to 12 months. The offence is one of strict liability and, accordingly, an officer and/or director may claim a defence of due diligence where he has made a *bona fide* effort to ensure that the corporation has complied with its filing obligations.

When Additional Income Taxes are Payable: Subject to claims of fraud, a director or officer of a corporation is generally not personally liable for income taxes or related penalties and/or interest assessed against a corporation, whether assessed initially or upon a subsequent audit. However, to the extent that a director or officer has made, participated in, assented to or

²⁰ CBCA, *supra* note 1, s. 241(2).

²¹ Federal Act, s. 159(2) and (3).

acquiesced in the making of a false or deceptive statement in a tax return, he could be found guilty of an offence and be subject to a fine and/or imprisonment.

4. LIABILITY TO OTHER CREDITORS OF THE CORPORATION

- (a) A director can be held personally liable in tort for damages suffered by a third party as a result of actions or omissions of the corporation even though there was no breach of the director's statutory duties.
- (b) A director can be held personally responsible for patent, copyright, trade secret or trade-mark infringement.
- (c) A director can be held personally liable to creditors if he engages in oppressive or unfairly prejudicial conduct towards them.

5. OTHER POTENTIAL SOURCES OF LIABILITY

(a) Construction Lien Act²² (the "CLA")

Part II of the CLA creates a number of statutory trusts whereby the amounts payable under a contract or subcontract are to be held in trust by the payer for the benefit of the suppliers of the labour and materials. Under section 13(1) of the CLA, a director or officer may be liable where the corporation breaches the terms of the trust provisions imposed by Part II, and the director or officer, "**assents to or acquiesces in, conduct that he or she knows or reasonably ought to know amounts to breach of trust by the corporation.**"

(b) Competition Act

Directors and officers can be charged criminally for conspiracy (section 45) or bid-rigging (section 47) under the *Competition Act*.²³ In both cases, the individual director or officer has to be directly involved in the impugned agreement or arrangement. Conviction of other offence is punishable by imprisonment for a term not exceeding 5 years or to a fine (in the discretion of the court for bid-rigging and not exceeding ten million dollars for conspiracy).

(c) Offences under the CBCA

The CBCA imposes quasi-criminal liability on directors of a corporation in certain circumstances. For example, it is an offence for a director to: fail to file any documents required to be filed under the CBCA, or fail to observe or comply with any directions, orders, decisions, rulings or other requirements under any provisions of the CBCA or the regulations.

²² R.S.O 1990, c. C.30.

²³ R.S.C. 1985, c. C-34.

Where the corporation itself is guilty of an offence, every director or officer who, without reasonable cause, authorized, permitted or acquiesced in the offence is also guilty of an offence.

(d) Workplace Safety and Insurance Act

There is potential liability under section 157 of the *Workplace Safety and Insurance Act, 1997*; this act deals with safety in the workplace and the applicable section states as follows:²⁴

“If a corporation commits an offence under this Act, every director or officer of the corporation who knowingly authorized, permitted or acquiesced in the commission of the offence is guilty of an offence, whether or not the corporation has been prosecuted or convicted.”

(e) Environmental Liability

Directors and officers can be held directly responsible for the failure to implement proper pollution control measures under a number of federal and provincial statutes.

(i) Federal Statutes and Penalties

A number of federal statutes regulating environmental matters impose criminal liability on any director, officer, or agent of a corporation who “**directed, authorized, assented to, acquiesced in or participated in**” a commission of an offence by the corporation under the statute, whether or not the corporation has been prosecuted or convicted. The effect of the wording of these statutes however is that for the purposes of federal environmental legislation, directors and officers will only be subject to liability if they had knowledge of the actions which constituted the offence.

(ii) Provincial Statutes and Penalties

Various offences laid out in a number of provincial environment-related Acts impose personal liability on directors or officers should a number of conditions be met. Generally, the provincial statutes are more explicit than federal environment-related acts in recognizing a duty on directors and officers to take all reasonable care to prevent the corporation from causing or permitting an offence. Hence, a director or officer may be subject to personal liability notwithstanding that they had no knowledge of the offence; they have an obligation to act proactively to ensure that the corporation is in compliance with the provincial environmental protection statutes.

Directors or officers will not be held liable for most of the offences under the environmental protection legislation if they can prove they exercised all due diligence to prevent commission of the offence.

²⁴ S.O. 1997, c.16, Schedule A.

In addition to the possibilities for regulatory breach, the question of personal tort liability in the environmental sector (*e.g.*, by derivative action) is also a concern. There are also powers granted to most environmental regulators to issue mandatory orders and there are precedents in Ontario where mandatory orders have been issued personally against directors and officers to compel them to undertake environmental clean-ups or respond to other requirements where the potential financial burden can be huge.

Thus, directors or officers in corporations whose operations fall within the purview of environmental protection legislation or in some way affect the environment must take positive steps to fulfil their environmental duties by setting up appropriate pollution monitoring, prevention and abatement systems.

In the environmental area, due diligence must begin with a comprehensive understanding of the environmental situation of the business or property. Typically, unless one has a strong in-house environmental capability, we recommend that an outside consultant be hired to begin with a property assessment and a compliance audit to provide the directors and officers with the basic information they need as a platform to begin their due diligence. Without that basic information, it appears to us almost impossible to satisfy an obligation to exercise "all reasonable care."