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AVOIDING DIRECTOR'S LIABILITY IN TROUBLED ECONOMIC TIMES

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A. INTRODUCTION

During troubled economic times, it is sometimes tempting for corporations, both not-for-profit and for-profit, to ignore their statutory obligations to remit certain amounts to the Crown in favour of meeting other financial obligations. However, corporations and their directors and officers who do so place both the organization and themselves at significant risk.[1] Contrary to a widely held misconception that directors' liability does not apply to directors of not-for-profit corporations, the Canada Revenue Agency ("CRA") has recently reaffirmed that the liability for source deductions applies to all directors in both profit and not-for-profit organizations.[2]

There are a large number of federal and provincial statutes that establish specific offences and penalties for acts and omissions committed by directors and officers of corporations. The reasoning behind imposing this direct liability on corporate directors and/or officers for the corporation's failure to abide by certain statutory

[1] See, for example, *Charity Law Bulletin No. 148*, entitled "Employee or Independent Contractor? Be aware of the risks," in which Barry W. Kwasniewski discussed the potential serious legal consequences for charities and non-profit organizations arising from an incorrect classification of staff between employee and independent contractors. This incorrect classification impacts directors of charities and not-for-profit corporations, particularly with respect to statutory liability for unremitted income tax and other source deductions. When it turns out an independent contractor is actually an employee, a situation which regularly arises when the person is laid-off or their contract terminated due to budgetary issues and a claim is made for employment insurance, the corporation has essentially failed to remit the appropriate taxes and source deductions, a circumstance which will aften exacerbate an already precarious financial situation. By statute, directors of the corporation are personally liable until the amounts are paid and the corporation may not have the necessary funds at its disposal .

[2] Document #2008-0295631I7, released on January 21, 2009. Technical interpretations are only available through commercial subscription services or a direct request to CRA.

requirements is that in order for the corporation to feel the full weight of the law, directors and officers must be exposed to the same liability of the corporation. This *Charity Law Bulletin* explores the basis for director's liability for unremitted source deductions and G.S.T pursuant to federal legislation[3] in the context of the recent CRAtechnical interpretation.

B. DIRECTOR'S LIABILITY

Liability risks for directors of charitable and not-for-profit corporations can arise at common law and by statute. One of the directors' common law duties includes ensuring that the corporation acts in accordance with the law, which includes remitting source deductions to the government and complying with other regulatory requirements. If the corporation does not do so, the directors can be held personally liable. A director can be held personally liable for his or her own actions or inactions, as well as jointly and severally with the other members of the board of directors. Jointly and severally means that should a director be found liable, he or she can recover from the other directors. Provided that the directors act with reasonable care, prudence and diligence in the circumstances, the directors can be seen as discharging his or her duty and escape liability. In particular, the director should take action to remedy the problem when becoming aware it, take steps to prevent future occurrence, and to seek advice from management and appropriate professionals.

During troubled economic times, directors need to be particularly aware of several statutory sources of liability including the *Income Tax Act*, *Excise Tax Act*, *Canada Pension Plan Act* and the *Employment Insurance Act*.

Section 227 of the *Income Tax Act* ("the ITA")[4] provides that where

> a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or 135.1(7) or section 153 or 215, has failed to remit such an amount or has failed to pay an 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, or solidarily, liable, together with the corporation, to pay that amount and any interest or penalties relating to it.

[3] For a discussion of various sources of statutory liability for directors and officers, please see Terrance S. Carter and Jacqueline M. Demczur, "*The Legal Duties of Directors of Charities and Not-for-Profits*" (November 2008), available at http://www.carters.ca/pub/article/charity/govset/A-duties.pdf.
[4] R.S.C. 1985, c. 1 (5th Supp.).

Under the ITA, directors are jointly and severally liable to pay all employee income tax deductions, as well as any interest and penalties related thereto, that the corporation has failed to remit to CRA. The liability of directors in this regard continues for two years after a director ceases to be a director.

Similarly, section 323 of the *Excise Tax Act* (the "ETA")[5] imposes joint liability on a director with respect to a corporation's "net tax" remittances and refunds. It provides that where

> … a corporation fails to remit an amount of net tax as required under subsection 228(2) or (2.3) or to pay an amount as required under section 230.1 that was paid to, or was applied to the liability of, the corporation as a net tax refund, the directors of the corporation at the time the corporation was required to remit or pay, as the case may be, the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay the amount and any interest on, or penalties relating to, the amount.

Section 21.1(1) of the *Canada Pension Plan Act*[6] states that

> … if 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 or solidarily liable, together with the corporation, to pay to Her Majesty that amount and any interest or penalties relating to it.

Section 46.1 of the *Employment Insurance Act*[7] states that if

> a penalty is imposed on a corporation under section 38 or 39 for an act or omission, the directors of the corporation at the time of the act or omission are, subject to subsections (2) to (7), jointly and severally, or solidarily, liable, together with the corporation, to pay the amount of the penalty.

Generally, to discharge the liability created by these statutes, a director must be able to show that he or she took positive action in seeing that the corporation complied with the statutory requirements. If the director can show that they exercised the degree of care, diligence and skill that a reasonably prudent person would exercise in the same circumstances, then they may not be found personally liable for any failures of the corporation to comply with its statutory obligations., The appropriate standard of care is discussed below in the context of the *Wheeliker* and *Rancourt* decisions.

[5] R.S., 1985, c. E-15.
[6] R.S., 1985, c. C-8.
[7] 1996, c. 23.

C. WHO IS A DIRECTOR?

While it is clear that individuals who are properly appointed as directors will be exposed to liability, *de facto* directors and, in certain circumstances, officers may also be found liable. Affirming CRA's *Information Circular 89-2R*,[8] the Tax Court of Canada has indicated that *de facto* directors are also exposed to potential liability.[9] *De facto* directors are generally senior officers, employees, and others who are not legally appointed as directors of the corporation, but who nevertheless perform the functions that directors would perform, e.g. direct the affairs of the corporation, whether or not they have represented themselves as directors to any third party.

Resigning as a director may not avoid liability, but the resignation will trigger the beginning of limitation period. For ITA and ETA purposes, a director remains liable for up to two years from the day he or she ceases to be a director. This essentially means that a director may be found liable for statutory amounts that were not remitted during his or her term, provided that the director is assessed for these amounts within the two-year period following his or her resignation. This does not mean that a director will be held liable for unremitted statutory amounts that arise after his or her resignation, provided that the director's resignation was done in accordance with the by-laws of the organization, the resignation was properly recorded, and the director ceased to be involved in the organization to the degree necessary to eliminate the possibility of being considered to have remained a *de facto* director.

D. THE WHEELIKER DECISION

In *Wheeliker v. Canada*,[10] the Federal Court of Appeal reviewed the issue of the standard of care for directors. This case involved volunteer directors of a not-for-profit corporation who were held personally liable for income tax the corporation owed to Revenue Canada. The directors were aware of the failure of the corporation to remit the sums, in some cases for up to a year, before the corporation was put into bankruptcy.

The Court found that the directors were liable for the sums due because they did not exercise the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances under subsection 227.1(3) of the ITA. Justice Letourneau commented that the standard of care was no less

[8] Information Circular 89-2R by CRA is available at http://www.cra-arc.gc.ca/E/pub/tp/ic89-2r2/ic89-2r2-e.pdf.
[9] *Bonotto v. The Queen*, 2008 DTC 3562 at para. 52.
[10] (1999), 172 D.L.R. (4th) 708.

rigorous for a director of a non-profit corporation than for a director of a corporation run for profit. He wrote that the application of the standard of care is a subjective one. This means that, as of learning of the financial difficulties of the Corporation or its failure to remit, all the directors were under a positive duty to address the problem and to prevent a failure to make future remittances.

This case requires directors of non-profit organizations to take positive steps to ensure that source deductions are remitted in order to escape liability. A failure to meet the standard of care will result in personal liability.

E. *RANCOURT V. QUEEN*, 2008TCC285

In *Rancourt v. The Queen*,[11] the issue was also about whether the standard of care was met by a director of a non-profit corporation. Unlike the *Wheeliker* decision, the director in this case was found to have discharged her duty.

In *Rancourt*, the corporation's activities involved distributing shows and operating a performance hall and bar under the name "L'Espace Alizé". The corporation failed to pay the amounts of net GST that it was required to remit under the ETA. The Minister of Revenue sought to have Rancourt, one of the directors, to be held liable for the outstanding amount and assessed accordingly. The Court found that for someone with limited business and management experience similar to that of Rancourt, actions by the corporation including the appointment of a new accountant, indicated that the decisions made by the directors were the ones needed to redress the corporation's financial situation and ensure that the GST remittances were paid. Rancourt met the standard of care by doing what a reasonably prudent person would have done in comparable circumstances.

The decisions in *Wheeliker* and *Rancourt* confirm that the standard of due diligence required is the same regardless of the nature of the corporation.[12] The standard of care that provides a defence for the director is one of exercising the degree of care, diligence and skill that a reasonable prudent person would have exercised in comparable circumstances.

[11] 2008 TCC 285, available at http://decision.tcc-cci.gc.ca/en/2008/2008tcc285/2008tcc285.html.
[12] 172 D.L.R. (4th) 708.

F. STEPS TO PREVENT LIABILITY

The case law provides guidance on what it views as the due diligence required to escape director's liability for unremitted statutory amounts. As the *Wheeliker* decision explains, once directors become aware of the failure of the corporation to remit source deductions, the directors bear a positive duty to take action to remedy the existing failure as well as to prevent future occurrences.[13] Directors also have a positive duty to ensure that statutory remittances are made and particular should be taken during troubled economic times to ensure that these remittances are not being ignored.

[13] Wheeliker, FCA at para. 27.

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