TAX COUNSEL

WHERE THE BUCK STOPS

DIRECTORS LIABILITIES

Directors are the operating minds and wills of corporations. They are the brains of the outfit. For this reason CCRA has imposed upon corporate directors significant personal liability in respect of employee remittances and GST.

A director is personally responsible for a corporation's ITA, CPP, EI and GST remittances.[1] This liability endures for a full two years after an individual ceases to be a director. Beyond that time period, CCRA can no longer initiate a pursuit of the director for his or her responsibilities.

Of course, by the time CCRA starts pursuing a director, the miscreant corporation is typically without funds. So if tagged, a director must usually dig deep into his or her own pocket without hope of recourse to anyone else.

The courts have categorized these directorial responsibilities as "strict liabilities". Directors are required to act as virtual trustees of remittance funds. The import of this is that there are very few defenses available to the director of a corporation that uses remittance funds for other purposes.

The exception is the statutory defense of due diligence[2]. A director may successfully employ this defense by demonstrating to the court that he or she has exercised the degree of care, skill and diligence of a reasonably prudent person in comparable circumstances to prevent the failure of the remittance.

The defining case for the defense of due diligence is Federal Court of Appeal case of *Soper v. Canada*[3]. In *Soper*, the court held that the due diligence test was "objective-subjective" in nature. In other words, when deciding whether a director has "exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have shown in comparable circumstances", a court must take into account the characteristics of the director whose conduct is in question, including his or her level of relevant skill, experience and knowledge. Thus a sophisticated businessperson will be held to a higher standard than a person with less knowledge or experience. Further, an inside director involved in the day-to-day management of the corporation and who influences the conduct of its affairs will have an extremely difficult time mounting a defense based on due diligence while an outside director has a better chance of success on this basis.

The very recent Federal Court of Appeal case of *Worrell and Lapointe v. Canada*[4] casts further light on the due diligence defense. In *Worrell*, the corporation was a thirty year old manufacturing business (ABEL) that had, until the recession of the late '80s and early '90s, always operated profitably. In 1993 it was in serious difficulty. Its debt had reached record levels and its bank started dishonouring cheques, including some in favor of the Receiver General of Canada. ABEL hired a C.A. whose specialty was turning construction companies around and whose opinion was that the corporation was viable. He located an investor to inject badly needed capital but ultimately the bank found that investor not acceptable. For the period of time between the first dishonored cheque and the date ABEL filed for bankruptcy, ABEL staff prepared but did not submit cheques for the employer portions of CPP and UI and for GST. Those items remained unpaid.

In most cases of this sort emphasis has been placed on directors' duties to <u>prevent</u> default of payment of these statutory obligations. It is usually not enough that vigorous attempts are made to cure the default after the fact. A typical scenario is one in which directors choose, albeit reluctantly, to pay creditors other than CCRA in the hope that the company's fortunes turn around and ultimately all debts will be paid. The Court in *Worrell* makes it clear that in such cases, it is the directors who assume the "risk" and not CCRA. The Court states: "Tax payers are not required involuntarily to underwrite this risk, no matter how reasonable it may have been from a business perspective for the directors to have continued the business without doing anything to prevent future failures to remit."

NOV/DEC 2000

"...emphasis has been placed on directors' duties to <u>prevent</u> default of these statutory obligations"

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WHERE THE BUCK STOPS (CONT'D)

"..for directors of troubled corporations to say, "My bank made me do it" is obviously not a sufficient answer to CCRA"

On the other end of the spectrum are cases in which a corporation is placed into formal receivership or bankruptcy. In such cases directors are neither physically nor legally able to prevent failure of remittances and are therefore usually allowed escape from liability.

Worrell is right in the middle. It is a case of "soft receivership". For a period of time prior to ABEL's formal bankruptcy its bank exercised "de facto" control over payables by simply refusing to honour certain cheques. At trial the Tax Court determined that this control was the most important factor in determining whether the directors were able to prevent failure of the remittances.

Not so, said Justice Evans of the Federal Court of Appeal. The control exercised by the bank was only one factor and not the most important one. Much more important was directors' reasonable reliance on the independent advice of the C.A. that a new investor could be found. Had the right investor been acquired, the bank would undoubtedly have loosened the purse strings and allowed those several prepared but unsubmitted cheques to be honoured. The efforts of the directors and the C.A. were thus directed towards preventing failure of the remittances and accordingly they were found "duly diligent" and exonerated of all personal liability.

In some ways, this case is difficult to distinguish from the "voluntary risk" cases but the important factor seems to be that the directors' efforts were directed not only to long-term profitability but also to the immediate problem at hand.

Therefore, for directors of troubled corporations to say that , "my bank (creditors, landlord) made me do it" is obviously not a sufficient answer to CCRA. The following due diligence guidelines may be of assistance. To the extent possible, directors should:

a) regularly inform themselves of the corporation's financial status;
b) treat remittance funds as someone else's money (as indeed they are);
c) consider advising CCRA of a problem upon discovering same in order to work out a solution;
d) in the event of a problem focus on the short term goal of payment of remittances.

This last suggestion may run counter to good business sense in that the short term focus may conflict with the longer term goal of corporate financial health. However, as ***Catch 22**'s* Yossarian found, what is good for the company may **not** be good for you.

[1] *ITA*, R.S.C. 1985, c. 1 (5th Supp), s. 227.1(1); *ETA*, R.S.C. 1985, c. E-15, s. 323(1)
[2] *ITA*, R.S.C. 1985, c. 1 (5th Supp), s. 227.1(3); *ETA*, R.S.C. 1985, c. E-15, s. 323(3)
[3] [1998] 1 F.C. 124
[4] Court file #A-426-98, decision rendered October 24, 2000 (Evans J.A., Stone J.A., Rothstein J. A.)

Suite 100 - 10328 - 81 Avenue
Edmonton, Alberta
Canada T6E 1X2

Tel (780) 439-7171
Fax (780) 439-0475

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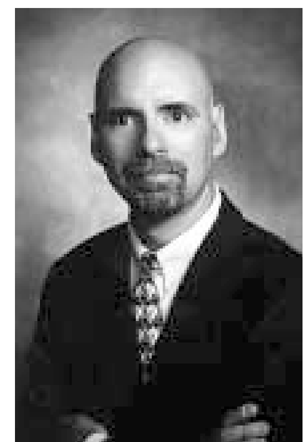
Donald P. Mallon, BSc LLB, a partner in Prowse & Chowne, is a seasoned litigator with over 20 years of experience. Focusing on administrative and tax litigation, he draws upon his courtroom and negotiation skills to effectively represent individual and business taxpayers in disputes with Revenue Canada.



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